

United States Court
Southern District of Texas
FILED

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Michael N. Newby, Clerk

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS
HOUSTON DIVISION

In re ENRON CORPORATION SECURITIES
LITIGATION

§ Civil Action No. H-01-3624

§ (Consolidated)

§

§ CLASS ACTION

§

This Document Relates To:

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MARK NEWBY, et al., Individually and On
Behalf of All Others Similarly Situated,

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Plaintiffs,

§

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vs.

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ENRON CORP., et al.,

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Defendants.

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THE REGENTS OF THE UNIVERSITY OF
CALIFORNIA, et al., Individually and On Behalf
of All Others Similarly Situated,

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Plaintiffs,

§

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vs.

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KENNETH L. LAY, et al.,

§

§

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Defendants.

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**LEAD PLAINTIFF'S REPLY BRIEF IN FURTHER SUPPORT OF ITS
MOTION FOR RECONSIDERATION OF ORDER DISMISSING CLAIMS
~~2145~~ AGAINST THE DEUTSCHE BANK DEFENDANTS
(DOCKET NO. 2145)**

2199

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I. INTRODUCTION

Prior to the Class Period, Deutsche Bank created, structured and funded fraudulent Structured Tax Deals (“STDs”) to falsify Enron’s financial results. As a result, Deutsche Bank knew Enron’s financial results during the Class Period were false. Nonetheless, during the Class Period, Deutsche Bank issued false analyst reports and sold Enron-securities via offering documents Deutsche Bank knew or recklessly disregarded to be false. Plaintiffs’ claims as to Deutsche Bank’s deceptive acts during the Class Period are not time-barred.

While it is true that liability for certain of Deutsche Bank’s fraudulent acts is foreclosed by the arbitrary influence of a mandated statute of repose, this does not excuse the defendant for its subsequent acts of deceit. The Supreme Court’s decision in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 364 (1991), may bind this Court’s discretion as to meting out proper justice to Deutsche Bank for its role in purposefully falsifying Enron’s financial results via the STDs – but the Supreme Court did not expressly or impliedly suggest the further draconian measure that Deutsche Bank’s knowledge of its own fraudulent conduct must also be swept away by legislative fiat. Rather, as this Court has previously determined, allegations concerning time-barred conduct are admissible for the purpose of proving the existence of scienter and/or a pattern of conduct in furtherance of a fraudulent scheme. *In re Enron Corp. Sec. Litig.*, 235 F. Supp. 2d 549, 689 (S.D. Tex. 2002). The Court’s dismissal of plaintiffs’ fraud claims as to Deutsche Bank contradicts the law of this case; accordingly, plaintiffs’ motion for reconsideration is proper.

Deutsche Bank raises several arguments to the contrary, each incorrect. Deutsche Bank asserts that Lead Plaintiff merely raises the same arguments that the Court has already considered and rejected. Deutsche Bank Entities’ Memorandum of Law in Opposition to Lead Plaintiff’s Motion for Reconsideration of March 29 Order Dismissing Claims Against Deutsche Bank Entities (“Opp.”) at 2. Deutsche Bank is mistaken. *See infra* §II.A. Deutsche Bank also contends plaintiffs’

scienter allegations are inadequate because Deutsche Bank did not know “the true financial condition of Enron.” Opp. at 4. Plaintiffs, however, more than adequately allege a strong inference that Deutsche Bank knew or recklessly disregarded that Enron’s financial results were materially falsified. *See infra* §II.B.1. The Court should consider all of plaintiffs’ allegations for scienter purposes even if the underlying conduct itself is time-barred. *See infra* §II.B.2. Moreover, plaintiffs’ allegations satisfy all applicable Fifth Circuit pleading standards. *See infra* §II.B.3. In sum, the Court should reconsider its prior dismissal of plaintiffs’ fraud claims as to Deutsche Bank.

II. ARGUMENT

A. Lead Plaintiff’s Motion Is Proper Under Rule 54(b)

Deutsche Bank erroneously asserts that plaintiffs’ motion is “entirely improper as plaintiffs only raise the same arguments already considered and rejected by this Court.” Opp. at 2. Plaintiffs disagree. As Lead Plaintiff pointed out in its moving papers:

Plaintiffs respectfully submit that the Court understandably focused on plaintiffs’ new allegations concerning the STDs alone, without considering whether other primary deceptive acts Deutsche Bank committed during the Class Period were performed with scienter demonstrated by significant pre-Class Period conduct.

Lead Plaintiff’s Motion for Reconsideration of Order Dismissing Claims Against the Deutsche Bank Defendants (“Motion”) (Docket No. 2101) at 1. The Court has *not* “already considered and rejected” Lead Plaintiff’s position.

As a result of the Court’s inadvertent failure to address the full scope of Lead Plaintiff’s claims, the March 29 Order is in error and Lead Plaintiff has properly moved for reconsideration. Deutsche Bank mistakenly argues that plaintiffs’ motion is improper because “plaintiffs have not identified any error of law [in the Court’s March 29 Order], nor can they.” Opp. at 2. However, plaintiffs plainly identify the legal error for which reconsideration is sought. *See, e.g.*, Motion at 2 (demonstrating that the March 29 Order is “inconsistent with the law of this case”). As further demonstrated below, Deutsche Bank’s attempt to assert otherwise is not persuasive.

B. Plaintiffs Sufficiently Plead Scienter

1. Plaintiffs Plead Facts Supporting a Strong Inference That Deutsche Bank Knew and/or Recklessly Disregarded that its Public Statements During the Class Period Were False and Misleading

Deutsche Bank incorrectly asserts: “Unlike other bank defendants, there has never been any particularized pleading that any DB Entity was privy to information concerning the true financial condition of Enron.” Opp. at 4. Deutsche Bank could not be more wrong. The Court expressly found that, while time-barred, plaintiffs had in all other respects “adequately and particularly stated a claim against the Deutsche Bank Entities as secondary actors committing primary violations of §10(b) and Rule 10b-5, *including facts giving rise to a strong inference of scienter on their part.*” March 29, 2004 Merrill/Deutsche Order at 40.¹ The Court goes on to state that Deutsche Bank’s “six distinct STDs, each described in some detail, violated GAAP by serving solely to falsely report inflated income for Enron ... [and] fraudulently inflate financial results.” *Id.* Plaintiffs adequately allege Deutsche Bank purposefully acted to fraudulently falsify Enron’s financial results.

Moreover, whether Deutsche Bank knew the “true financial condition of Enron” (as Deutsche Bank frames the issue) is a classic “red-herring.” Plaintiffs need not prove that Deutsche Bank knew exactly the amount of Enron’s off-balance sheet debt, or the exact amount that Enron had falsified its cash flow or earnings. Rather, the issue is whether Deutsche Bank’s employees created, structured, and executed the STDs to falsify Enron’s financial results in a material manner and therefore knew or severely recklessly disregarded that Deutsche Bank’s statements about Enron’s financial condition during the Class Period were false and misleading.

Similarly, Deutsche Bank employees were told by Enron that its actual debts were higher than what Enron and Deutsche Bank were reporting to the public. Here, as the Court recognized in

¹ Emphasis is added and citations and footnotes are omitted unless otherwise noted.

the March 29, 2004 Order, Enron's Bankruptcy Examiner found that by early 2000 Deutsche Bank knew "the extent of Enron's off-balance sheet obligations could not be discerned from its financial statements" and that Deutsche Bank "requested and received information" from Enron about certain off-balance sheet obligations not otherwise disclosed to investors. March 29, 2004 Merrill/Deutsche Order at 40 n.33. Deutsche Bank argues that it cannot be liable because Enron "*mised*" Deutsche Bank as to the full extent of Enron's off-balance sheet debt and because Deutsche Bank was "surprised to learn" that Enron had additional obligations it did not reveal to Deutsche Bank. Opp. at 5. This is the same argument already offered by every bank defendant in this action, and rejected. Whether or not a bank defendant knew the full extent of Enron's true financial condition is irrelevant. This is especially so if the bank defendant knew or severely recklessly disregarded that its representations concerning Enron's publicly reported financial results were false. Here, the Complaint alleges Deutsche Bank itself acted to falsify Enron's financial results and Deutsche Bank knew or severely recklessly disregarded that Enron was not accurately reporting its off-balance sheet debt levels. Accordingly, Deutsche Bank allegedly knew its statements concerning Enron's financial condition were false and misleading regardless of whether Deutsche Bank knew the full extent of Enron's financial fabrications.

2. Deutsche Bank Cannot Reconcile the Court's December 20, 2002 Order With the Court's March 29, 2004 Order Concerning Plaintiffs' Scierter Allegations

In its moving papers, Lead Plaintiff demonstrated that the dismissal of fraud claims as to Deutsche Bank's false statements during the Class Period was inconsistent with the Court's Order dated December 20, 2002. Motion at 2-3. The Court previously acknowledged that even where liability is foreclosed by the passage of time, allegations pre-dating the period of repose may be considered in proving a defendant's Class-Period knowledge or in alleging a pattern and practice amounting to a scheme. *Enron*, 235 F. Supp. 2d at 689.

Deutsche Bank's attempt to recast this conclusion as *dicta* is unavailing. Opp. at 3. Deutsche Bank's argument relies upon an improper reading of the December 20, 2002 Order that conflates the analysis of scienter with that of scheme liability. Opp. at 3-4 ("The term 'scheme' is thus similar to scienter in that both reference the defendant's *intent*, rather than the defendant's *actions*." (emphasis in original). Scienter and scheme are not "similar" and the Court did not merely look to the defendants' intent to determine whether they committed primary acts in furtherance of a fraudulent scheme. Citing the Second Circuit scheme case *SEC v. U.S. Envtl., Inc.*, 155 F.3d 107 (2d Cir. 1998), the Court made its position on this matter clear by stating that "*scienter was a separate issue* and not relevant to the Supreme Court's holding in *Central Bank* that aiders and abettors cannot be primary violators under §10(b), the Second Circuit focused on the complaint's allegations about the nature of the employee's own acts, not his state of mind when he performed them." *Enron*, 235 F. Supp. 2d at 592. Because the December 20, 2002 Order expressly recognizes that the analysis of scienter is a "separate issue" from the analysis of what constitutes primary acts in furtherance of a fraudulent scheme, Deutsche Bank's attempt to reconcile the December 20, 2002 and March 29, 2004 Orders is without any basis.

3. Plaintiffs' Scienter Allegations and the Court's December 20, 2002 Order Comport With Applicable Pleading Requirements

Deutsche Bank asserts the Fifth Circuit's recent opinion in *Southland Sec. Corp. v. Inspire Ins. Solutions*, 365 F.3d 353 (5th Cir. 2004), as support for its contention that plaintiffs fail to properly allege scienter as to Deutsche Bank. Opp. at 6. Notably, *Southland* is not directly on point here because it does not concern an investment bank defendant, nor does it concern the issuance of false offering documents for the sale of securities to the public or the issuance of false analyst reports. Rather, in *Southland*, the Fifth Circuit merely determined that to properly plead fraudulent intent as to a corporation that plaintiffs must allege that some employee of the company acted to deceive. 365 F.3d at 366. In other words, plaintiffs cannot allege scienter by claiming that the

aggregate of various employees' knowledge was sufficient to demonstrate that a corporate defendant "knew" it had made a statement that was false. *Id.*

Regardless of whether *Southland* is applicable to the facts in this case, plaintiffs' allegations do comply with the standard set forth by the Fifth Circuit because plaintiffs have pled a strong inference of scienter as to a number of Deutsche Bank bankers. As demonstrated above, the Deutsche Bank bankers who worked on the fraudulent STDs knew Enron's financial statements to be false, as did other Deutsche Bank employees who worked on the Enron account. These Deutsche Bank employees had a responsibility to ensure that Deutsche Bank did not issue statements contrary to the material, non-public information known to them. Accordingly, plaintiffs' allegations are sufficient to plead scienter as to Deutsche Bank.

a. Plaintiffs Do Not Rely on the Collective Scienter Doctrine Rejected by the Fifth Circuit

Deutsche Bank incorrectly argues: "Plaintiffs' one-entity approach to pleading relies on the collective knowledge doctrine explicitly rejected by the Fifth Circuit and is thus inadequate." Opp. at 6 (citing *Southland*). Plaintiffs need not, and do not, rely upon the theory of "collective scienter." Deutsche Bank misconstrues the theory of collective scienter. Collective scienter measures the *mens rea* of a corporation by "the collective knowledge of all the corporation's officers and employees acquired in the course of their employment." *Southland*, 365 F.3d at 366. Collective scienter is applied where **no** individual employee acted with the requisite intent to commit fraud. *Id.* Here, as the Court has recognized, numerous Deutsche Bank bankers who worked on the STDs must have known that they were falsifying Enron's financial results. The Enron's Bankruptcy Examiner's

findings fully support plaintiffs' allegations. Accordingly, plaintiffs need not rely upon the theory of "collective scienter" to prove Deutsche Bank's scienter.²

b. The Scienter of Deutsche Bank Bankers Is Imputed to the Company Under Fifth Circuit Authority

Citing *Southland*, Deutsche Bank suggests that the proper scienter analysis is limited to only the "individual corporate official or officials who make or issue the statement." Opp. at 6. Deutsche Bank unnecessarily limits the Fifth Circuit's holding. *Southland* recognizes that scienter is properly pled so long as 1) some individual employee of a company knew or recklessly disregarded that the company's statements were untrue; and 2) the company employee is in some way connected with the false statement that caused plaintiff's injury:

For purposes of determining whether a statement made by the corporation was made by it with the requisite Rule 10(b) scienter we believe it appropriate to look to the state of mind of the individual corporate official or officials who make or issue the statement (*or order or approve it or its making or issuance, or who furnish information or language for inclusion therein, or the like*) rather than generally to the collective knowledge of all the corporation's officers and employees acquired in the course of their employment.

365 F.3d at 366. Here, plaintiffs plead that Deutsche Bank's bankers knew that Deutsche Bank's statements concerning Enron's financial statements were false. Moreover, each of these bankers was

² Plaintiffs have previously asserted that Deutsche Bank's scienter could be, but need not be, assessed under the collective knowledge doctrine recognized by other circuits. See Memorandum of Points and Authorities in Opposition to Motion to Dismiss by Deutsche Bank AG (Docket No. 848) at 102-03. As set forth by the Seventh Circuit, "the Supreme Court has noted that corporations face direct liability under section 10(b) of the 1934 Act and Rule 10b-5.... Indeed, there are conceivable situations where the individual actors would not be liable but their corporate employer would be, for example where a case depends on the collective scienter of its employees or where defenses are available to individuals but not the corporation." *Caterpillar v. Great Am. Ins. Co.*, 62 F.3d 955, 962 (7th Cir. 1995). Plaintiffs, however, never *relied* upon the collective knowledge doctrine but merely raised this assertion as one of many alternative means by which the Court could find Deutsche Bank liable. It is axiomatic that plaintiffs may plead in the alternative. See *Guy James Constr. Co. v. Trinity Indus., Inc.*, 644 F.2d 525, 530 (5th Cir. 1981) ("A party may plead alternative and inconsistent facts or remedies against several parties without being barred.").

obligated to stop Deutsche Bank from issuing the false statements at issue here – but did not. Accordingly, plaintiffs have adequately alleged scienter as to Deutsche Bank.³

**(1) Deutsche Bank's Scienter Argument Is Incorrect
as to Deutsche Bank's False Analyst Statements**

In attempting to narrow the Court's scienter analysis to only the Deutsche Bank employee(s) who made or issued Deutsche Bank's analyst reports, Deutsche Bank disregards the inner-workings of its corporate structure that differentiate it (and other full-service investment banks) from other corporate entities. For instance, the SEC has determined that such full-service investment banks maintain, as they are required to, specific procedures designed to ensure that research reports comport with all material information known to the bank as a whole (not just information known to a specific analyst authoring the research report):

The Division found that the issue of the publication of research reports while the investment banking department is in possession of material, nonpublic information resulted in a variety of procedural responses. All firms noted that the compliance department routinely reviews research reports prior to publication for a variety of reasons not directly connected to Chinese Wall Procedures. The majority of firms reported that research reports routinely are pulled, or at least delayed, when the compliance or investment banking department, by virtue of its knowledge of confidential information, determines that the research recommendation is damaging or incorrect.

Ex. 1 at 80,623. These procedures are intended to ensure that any Deutsche Bank banker with material, non-public information about a client stops the issuance of a false and misleading analyst report. Concerning Enron, Deutsche Bank did not do so.

³ It is inconsequential that plaintiffs have not named any of the specific Deutsche Bank bankers as defendants in this action. Plaintiffs plead a claim as to Deutsche Bank if any Deutsche Bank "director, officer or employee" acted with scienter, regardless of whether that person is a named defendant. *Southland*, 365 F.3d at 368; see also *In re Blockbuster Inc. Sec. Litig.*, No. 3:03-CV-0398-M, 2004 U.S. Dist. LEXIS 7173, at *56 n.5 (N.D. Tex. Apr. 26, 2004) ("In order to plead an inference of scienter with respect to Blockbuster, Plaintiffs could attempt to impute to Blockbuster the scienter of officers, directors, or employees of Blockbuster who are not named as Individual Defendants in this action.").

Moreover, Deutsche Bank's analysis contradicts its own research reports. Whereas during the Class Period Deutsche Bank told investors that Deutsche Bank as a whole believed the reports to be accurate, Deutsche Bank now instructs this Court to engage in a very narrow scienter analysis that disregards the knowledge of certain Deutsche Bank employees. For instance, during the Class Period, certain Deutsche Bank analyst reports contained the following disclosure:

This publication has been prepared by and reflects the current view of Deutsche Bank Securities Inc., and reflects the view of its ultimate holding company Deutsche Bank AG. This publication is provided to you for information purposes and is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The information contained herein has been obtained from sources believed to be reliable but is not necessarily complete and its accuracy cannot be guaranteed.... Deutsche Bank Securities Inc. has accepted responsibility for the distribution of this report in the United States under applicable requirements.... This publication is prepared by Deutsche Bank Securities Inc.

Ex. 2 at ANARPT002098. Other Deutsche Bank reports contained slightly different disclosures, but still intimated that Deutsche Bank as a whole believed the report to be accurate. Because numerous Deutsche Bank bankers knew Enron's financial statements to be false, the statements made in Deutsche Bank's analyst reports did not "reflect[] the view of its ultimate holding company Deutsche Bank AG." This is sufficient to plead scienter as to Deutsche Bank.

Indeed, this Court has repeatedly recognized that fraudulent statements issued in analyst reports by an investment bank are statements by the bank, and it is the scienter of the bank and each of its individual employees that is relevant. Addressing claims of common law fraud against Citigroup, the Court recently held that "allegations of ... direct, extensive involvement in significant fraudulent transactions are sufficient to give rise to a reasonable inference that Citigroup/Salmon Smith Barney was aware that the statements in the prospectuses and registration statements ***and its own public recommendations of Enron's securities*** through October of 2001 were false and misleading." *In re Enron Corp. Sec. Litig.*, No. H-01-3624, 2003 U.S. Dist. LEXIS 25038, at *39-*40 (S.D. Tex. Dec. 10, 2003). Similarly, the Court determined with respect to Lead Plaintiff's

claims: “*The alleged absence of effective Chinese walls*, which the Court has found adequate in light of the totality of the circumstances, *makes knowledge gained in the lending and commercial areas of the banks imputable to their analysts.*” *Enron*, 235 F. Supp. 2d at 689.

Deutsche Bank’s attempt to isolate the Court’s scienter analysis to only the individuals who made or issued its analyst reports is tantamount to a “Chinese Wall” defense. However, courts have repeatedly rejected this defense. “Although the use of Chinese Walls has been widespread for over two decades, *there remains no definitive judicial statement that these procedures constitute a legal defense to various charges of corporate liability.*” Pitt & Groskaufmanis, *Minimizing Corporate Civil & Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 Geo. L.J. 1559, 1617-18 (1990) (citing Doty & Powers, *Chinese Walls: The Transformation of a Good Bus. Practice*, 26 Am. Crim. L. Rev. 155, 157 (1988) (“*We know of no case ... in which a federal court accepted a [C]hinese wall defense on behalf of an integrated securities firm.*”)). Even if the Court were to entertain a Chinese Wall defense in this action, doing so would be inappropriate on a motion for dismissal pursuant to Fed. R. Civ. P. 12(b)(6). *Cooper v. Pickett*, 137 F.3d 616, 628-29 (9th Cir. 1998) (denying Chinese Wall defense and upholding complaint against investment bank defendants who issued false and misleading analyst reports as part of fraudulent scheme). Such a defense is inherently fact-specific and not appropriate at this stage of the proceedings.⁴ Accordingly, Deutsche Bank’s argument is improper here.

⁴ [T]o have its corporate code reach the status of a legal defense, the company must demonstrate not only that the code was properly crafted, but that it was enforced. The company’s records should reflect the effective corrective steps taken any time it discovered a violation of policy. At present, judicial and governmental skepticism abounds about the quality of corporate codes and, perhaps more importantly, the quality of their enforcement. The compliance program must provide an ample paper trail to offset that skepticism.

**(2) Deutsche Bank's Scienter Argument Is Incorrect
as to the False Offering Documents it Issued**

“An underwriter of a public offering risks exposure to ... liability under §10(b) for any material misstatements or omissions in the registration statement made with scienter, and thus has a duty to investigate an issuer and the securities that the underwriter offers to investors.” *Enron*, 235 F. Supp. 2d at 612. Here, Deutsche Bank knowingly and/or severely recklessly sold securities to investors via false and misleading offering documents, which is actionable under §10(b). *See, e.g.*, ¶641. Deutsche Bank contradicts well-established industry practice and law concerning the importance of an underwriter's due diligence obligations by suggesting that the Court limit its scienter analysis to only the few persons who actually made or issued the offering documents alleged to be false and misleading. *See, e.g., Chris-Craft Indus. v. Piper Aircraft Corp.*, 480 F.2d 341, 370-71 (2d Cir. 1973) (describing importance of underwriter's due diligence obligations).

In application, an investment bank has strict procedures for ensuring that all information in its possession – or known to its affiliates – is maintained by the investment bank in a central repository and provided to persons performing due diligence on an offering. This is for good reason, an underwriter is obligated to perform a reasonable investigation to ensure that offering documents are accurate. An investigation is patently inadequate if it does not discover facts known to employees of the underwriter and/or its affiliates demonstrating that the offering documents are false. For instance, Citigroup's internal Legal and Compliance Departments succinctly stated in a November 1999 memorandum Citigroup's policy concerning underwriting due diligence and the attribution of knowledge to Citigroup's underwriting business units:

Pitt and Groskaufmanis, 78 Geo. L.J. at 1645. And, “the corporate defendant should bear the burden of proving the existence of an effective compliance program.” *Id.* at 1648.

When SSB [Citigroup subsidiary Salomon Smith Barney] is the underwriter of debt or equity securities for a customer, SSB performs due diligence regarding the customer to assure that all material information regarding the issuer is available to potential investors and to establish a defense to potential liability for material misstatements and omissions. If SSB failed to access confidential information in the possession of an affiliate that impeached the customer's disclosures, it could be a fatal flaw to SSB's due diligence defense. ***Relevant information in the possession of all areas of Citigroup is attributable to SSB as underwriter.*** In this situation, it will be necessary for the SSB team working on the underwriting to have access to all relevant confidential customer information within SSB, Citibank or other business affiliates. If a business unit with relevant information is subject to a confidentiality agreement, which would not permit the sharing of information, the customer must consent to the sharing of the information in order for SSB to proceed with the underwriting. ***Neither a confidentiality agreement nor any internal "wall" will protect SSB from having such relevant information attributed to it.***

Ex. 3.⁵ Citigroup's policies concerning due diligence are reflective of the industry as a whole and demonstrate the industry's clear understanding that material, non-public information known to any employee of an underwriter (or its affiliate) is imputed to the underwriter. Here, as demonstrated above, numerous Deutsche Bank employees worked on the STDs to falsify Enron's financial results and/or otherwise knew Enron's financial statements were false. *See supra* §II.B.1. These employees' scienter is attributed to Deutsche Bank. Accordingly, the false statements made by Deutsche Bank as an underwriter of Enron securities are actionable under §10(b) of the Securities Exchange Act.

C. Plaintiffs Plead Subject Matter Jurisdiction

"Dismissal [for lack of subject matter jurisdiction] is proper only when 'it appears certain that the plaintiffs cannot prove any set of facts in support of their claim which would entitle them to relief.'" *Robinson v. TCI/US West Communs. Inc.*, 117 F.3d 900, 904 (5th Cir. 1997) (quoting *Saraw Partnership v. United States*, 67 F.3d 567, 569 (5th Cir. 1995)). Deutsche Bank argues that

⁵ Plaintiffs have been unable to locate Deutsche Bank's due diligence policies within Deutsche Bank's document production in this matter, and are uncertain as to whether Deutsche Bank has produced such documents. Regardless, Citigroup's due diligence policies sufficiently indicate industry norms.

the securities laws' silence as to extraterritorial reach robs this Court of subject matter jurisdiction as to Enron securities sold overseas. Opp. at 8. Deutsche Bank is incorrect. "Congress [did not] intend[] to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners." *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1017 (2d Cir. 1975). Viewing plaintiffs' allegations in the light most favorable to Lead Plaintiff, subject matter jurisdiction is satisfied.

In upholding plaintiffs' §10(b) claims against Citigroup, CSFB and CIBC as to the Foreign Debt Securities, this Court implicitly found plaintiffs adequately pleaded subject matter jurisdiction as to all aspects of the fraudulent course of conduct associated with the Enron Ponzi scheme alleged in this action, including defendants' Regulation S offerings. Indeed, plaintiffs plead the Regulation S offering documents incorporated by reference Enron's financial statements made false by defendants' course of conduct in the United States. It is this fraudulent course of conduct within the United States involving the Foreign Debt Securities that invokes subject matter jurisdiction and defeats Deutsche Bank's claim for dismissal.

While it is true, as argued by Deutsche Bank, that the securities laws are silent as to the extraterritorial extent of the American securities laws and the extent to which American courts have subject matter jurisdiction to hear suits involving foreign transactions, this void has been filled through case law. *Robinson*, 117 F.3d at 905. Here, the applicable test for subject matter jurisdiction over the Foreign Debt Securities, including the Regulation S offerings, is the conduct test, *i.e.*, "whether the fraudulent conduct that forms the alleged violation occurred in the United States." *Id.* See also *Sloane Overseas Fund, Ltd. v. Sapiens Int'l Corp., N.V.*, 941 F. Supp. 1369, 1374 (S.D.N.Y. 1996) (applying conduct and effects test to the 1933 and 1934 Acts). Plaintiffs have pleaded that the fraudulent conduct, the Enron Ponzi scheme, harmed plaintiffs who invested in the Foreign Debt Securities:

As an integral part of the fraudulent scheme complained of, Enron and certain other participants in the scheme [including Deutsche] sold billions of dollars of publicly traded securities which were issued by entities related to Enron and dependent on Enron's credit, financial condition and ability to pay in a series of offerings in Europe during 00 and 01.

¶641.1. *See also* ¶¶641.3-6, 641.17-24, 641.37-44. Whether the “[s]ales of the Foreign Debt Securities under Regulation S were conducted entirely outside the United States to non-U.S. investors” is irrelevant. *See* Opp. at 8. It is the fraud occurring within the United States and the harm caused to non-U.S. investors that is the essence of the conduct test. Here, jurisdiction is established because plaintiff purchasers of the Foreign Debt Securities were harmed by Deutsche Bank's and the other defendants' conduct occurring in the United States.

Moreover, Deutsche Bank is simply wrong to assert that plaintiffs attempt to apply U.S. securities laws to transactions “conducted entirely outside the United States to non-U.S. investors.” *Id.* The Court need look no further than the Offering Memoranda used to sell the securities in question to see that an adequate nexus to the United States exists for the purpose of establishing jurisdiction in the United States under the federal securities laws. For example, the offering memorandum for the 7.797% and 6.357% Senior Notes due 2003 issued 9/28/00 by Osprey Trust Osprey I, Inc. (¶641.21), indicates that the notes are “governed by, and construed in accordance with, the laws of the state of New York.” Ex. 4 at 11. The issuer of the notes, Osprey Trust, is a Delaware corporation with its principal offices in Wilmington, Delaware. *Id.* at i, 99. The underwriters in the offering (a.k.a. as initial purchasers) all list primary addresses in the United States, New York City and Stamford, Connecticut. *Id.* at 99. All of the legal advisors for the offering represented that their offices are located in the United States, including Vinson & Elkins whose location is listed as Houston, Texas. *Id.* And, the offering memorandum specifically refers purchasers to Enron's SEC filings and other documents, which are incorporated by reference, and which are made available to investors in the notes at various locations throughout the United States.

Id. at vii and 92. Thus, a simply review of the offering memoranda demonstrates the Court has subject matter jurisdiction with respect to the securities issued overseas. The case law is in accord. Deutsche Bank cites no authority to the contrary. Plaintiffs adequately plead subject matter jurisdiction.⁶

⁶ In response to Deutsche Bank's request for clarification, plaintiffs note that Deutsche Bank vacillates between asserting that all of plaintiffs' claims as to offerings prior to January 14, 2000 are time-barred and the more specific assertion that plaintiffs' 1933 Act claims are time-barred. *Opp.* at 9. Plaintiffs' 1934 Act claims against Deutsche Bank AG, which entity was named in plaintiffs' Consolidated Complaint filed on April 8, 2002, are not properly subject to Deutsche Bank's argument. Plaintiffs' claims as to Deutsche Bank AG arising from the same 'fraudulent Ponzi scheme alleged in the Consolidated Complaint, including Deutsche Bank AG's sale of securities to the public, relate back to that filing and are not time-barred unless they pre-date April 8, 1999. *See, e.g.,* March 29, 2004 Merrill/Deutsche Order at 64 (Rule 15(c) analysis finding STD "claims are also part of that same conduct set forth in the first consolidated pleading, if viewed in the context of the alleged Ponzi scheme" and therefore relate back to initial filing).

III. CONCLUSION

For the foregoing reasons, and as set forth in plaintiffs' moving papers, plaintiffs respectfully request the Court reinstate plaintiffs' §10(b) and §20(a) claims against Deutsche Bank for its actions committed during the Class Period.

DATED: June 11, 2004

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing LEAD PLAINTIFF'S REPLY BRIEF IN FURTHER SUPPORT OF ITS MOTION FOR RECONSIDERATION OF ORDER DISMISSING CLAIMS AGAINST THE DEUTSCHE BANK DEFENDANTS (DOCKET NO. 2145) document has been served by sending a copy via electronic mail to serve@ESL3624.com on this June 11, 2004

I further certify that a copy of the foregoing LEAD PLAINTIFF'S REPLY BRIEF IN FURTHER SUPPORT OF ITS MOTION FOR RECONSIDERATION OF ORDER DISMISSING CLAIMS AGAINST THE DEUTSCHE BANK DEFENDANTS (DOCKET NO. 2145) document has been served via overnight mail on the following parties, who do not accept service by electronic mail on this June 11, 2004

Carolyn S. Schwartz
United States Trustee, Region 2
33 Whitehall Street, 21st Floor
New York, NY 10004



Mo Maloney

Exhibit 1

tration requirement of Section 12(a) of the Act, solely for the purpose of inclusion in a standardized market basket, provided that all of the following terms and conditions are met:

(1) the standardized market basket has been duly approved by the Commission for listing on a national securities exchange pursuant to the requirements of Section 19(b) of the Act; and

(2) the stock is a National Market System security as defined in Rule 11Aa2-1 under the Act [17 CFR 240.11Aa2-1] and is either (i) listed and registered for trading on a national securities exchange by the issuer or (ii) quoted on the National Association of Securities Dealers Automated Quotation System;

(b) When used in this rule, the term "standardized market basket" means a group of at least 100 stocks purchased or sold in a single execution and at a single trading location with physical delivery and transfer of ownership of

each component stock resulting from such execution.

By the Commission.

REGULATORY FLEXIBILITY ACT CERTIFICATION

I, Richard C. Breeden, Chairman of the Securities and Exchange Commission, hereby certify pursuant to 5 U.S.C. 605(b) that proposed Rule 12a-7 set forth in Securities Exchange Act Release No. 27834, if promulgated, will not have a significant economic impact on a substantial number of small entities. The reasons for this certification are that (1) the proposed rule would exempt from the registration provisions of Section 12(a) of the Act only those securities that are traded as part of a standardized market basket and (2) the trading of stocks on an exchange as part of a standardized market basket would not have a significant impact on the markets for the individual securities comprising the basket.

[§ 84,520] Broker-Dealer Policies and Procedures Designed to Segment the Flow and Prevent the Misuse of Material Non-Public Information.

Report by the Division of Market Regulation, March, 1990. Report in full text.

Exchange Act—Broker-Dealers—Inside Information.—Regarding broker-dealer procedures to prevent the misuse of inside information, the Division noted that necessary improvements to the status of broker-dealer "Chinese Walls" would best be effectuated by self-regulatory examination programs, supplemented by SEC oversight, rather than by SEC rulemaking.

See § 25,221, "Exchange Act—Broker-Dealer Regulation" division, Volume 3.

EXECUTIVE SUMMARY

In November 1988, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), designed primarily to prevent, deter, and prosecute insider trading. Section 15(f) of the Securities Exchange Act of 1934, created pursuant to the promulgation of ITSFEA, requires broker-dealers to maintain procedures designed to prevent the misuse of material, nonpublic information. This section also grants the Securities and Exchange Commission ("Commission") broad rulemaking authority concerning these so-called Chinese Wall procedures. Pursuant to this grant of rulemaking authority, the Commission's Division of Market Regulation ("Division") undertook a comprehensive review of broker-dealer policies and procedures.

In its review, the Division noted improvements to procedures employed by major New York broker-dealers, as compared to a more narrow scope Chinese Wall review conducted in 1987. Despite these improvements, however, the Division noted certain deficiencies, and identified certain practices that are necessary elements of an adequate Chinese Wall. These minimum elements include review of employee

and proprietary trading, memorialization and documentation of firm procedures, substantive supervision of interdepartmental communication by the firm's compliance department, and procedures concerning proprietary trading when the firm is in possession of material, nonpublic information.

The Division determined that necessary improvements to the status of broker-dealer Chinese Walls would best be effectuated not by Commission rulemaking, but by self-regulatory examination programs, supplemented by Commission oversight. The Division will continue to examine these programs closely, and will revisit the issue of Commission rulemaking should it determine that necessary improvements are not being made through the oversight program, or that there exist deficiencies that are impossible to remedy through the actions of the self-regulatory organizations.

I. Introduction and Background

In November 1988, Congress enacted the Insider Trading and Securities Fraud Enforcement Act of 1988 ("ITSFEA"), designed primarily to prevent, deter, and prosecute insider

trading.¹ Among other provisions, ITSFEA creates a specific requirement for broker-dealers to maintain procedures designed to prevent the misuse of material, nonpublic information.² Further, ITSFEA grants the Securities and Exchange Commission ("Commission") the authority to promulgate rules or regulations to require specific policies or procedures designed to prevent the misuse of such information.³ In the legislative history accompanying ITSFEA, the House Committee on Energy and Commerce noted that although the Commission has indicated that flexibility is necessary to permit diverse institutions to tailor their policies to fit their particular business conditions, the Commission should retain broad rulemaking authority should it become dissatisfied with either the overall quality of broker-dealer policies and procedures, or any specific aspect of the programs in place.⁴ In response to the legislation and the concomitant grant of rulemaking authority, the Division of Market Regulation ("Division") undertook a comprehensive review of broker-dealer policies and procedures.⁵ The Division also has reviewed the status of self-regulatory organization ("SRO") oversight of member firm activity concerning Chinese Walls, and the potential utility of Commission rulemaking in response to the Division's findings. The findings and conclusions of the Division, along with recommendations concerning broker-dealer procedures and SRO responsibilities, are contained in this report.

The existence of broker-dealer Chinese Walls, both as a prophylactic against illegal activity and a legal defense for broker-dealers against liability in an insider trading context, predates the recent legislation.⁶ The existing regulatory requirements for adequate Chinese Wall procedures also is reinforced by newly created Sections 21A(a)(1) and (3) of the Act. These provisions of ITSFEA provide that the controlling person of a person that has violated the Act by purchasing or selling securities when in possession of material, nonpublic information or by communicating such information in connection

with a purchase or sale, is liable for up to the greater of \$1,000,000 or three times the profit gained or loss avoided. Section 21A(b), however, provides that no controlling person shall be held liable under subsection (a) unless the Commission establishes either that the controlling person knew or recklessly disregarded the fact that the controlled person was likely to take the act or acts constituting the violation and failed to take appropriate steps to prevent such acts, or that the controlling person failed to establish, maintain, or enforce its procedures required under Section 15(f), and that failure contributed substantially to the act or acts constituting the violation.

Broker-dealer Chinese Walls have evolved to include policies and physical apparatus designed to prevent the improper or unintended dissemination of market sensitive information from one division of a multi-service firm to another (i.e. from the mergers and acquisitions area to proprietary or retail trading), and trading procedures and reviews designed to prevent and detect illegal trading.⁷ Within this very general framework utilized by the majority of multi-service broker-dealers, no two systems are alike, ranging from very tight centralized control of information and review to little or no review or follow-up.

The Commission previously has examined the regulatory impact of broker-dealer Chinese Walls: In 1980, the Commission promulgated Rule 14e-3, an antifraud provision which prohibits the trading of securities which may be the subject of a tender offer while in possession of material nonpublic information.⁸ Paragraph (b) of Rule 14e-3 provides a safe harbor for transactions by multi-service financial institutions under certain circumstances that otherwise would be proscribed under Rule 14e-3(a), provided, among other factors, that the firm has established policies and procedures, reasonable under the circumstances, to ensure that the individuals making the investment decisions for the firm were not trading on the basis of material nonpublic information obtained from another

¹ Pub. L. No. 100-704.

² 15 U.S.C. § 78o(f). Section 15(f) of the Securities Exchange Act of 1934 ("Act") reads, in pertinent part, "Every registered broker or dealer shall establish, maintain, and enforce written policies and procedures reasonably designed, taking into consideration the nature of such broker's or dealer's business, to prevent the misuse in violation of this title, or the rules and regulations thereunder, of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer." The Act also creates an identical obligation for investment advisors. See 15 U.S.C. § 80b-204A.

³ 15 U.S.C. § 78o(f).

⁴ See H.R. Rep. No. 910, 100th Cong., 2d Sess. 22 (1988). The legislative history noted that the "reasonably designed to prevent" language in paragraph (f) is similar to the

rulemaking provisions contained in Sections 14(e) and 15(c)(2) of the Act, and is intended to ensure that Commission rulemaking authority extends beyond the specific requirements of Section 15(f). *Id.* at n.20.

⁵ Policies and procedures employed by broker-dealers to segment the flow of sensitive information often are referred to collectively as "Chinese Walls."

⁶ See generally Poser, *Chinese Walls in the U.S. and the U.K.*, Securities and Commodities Regulation 210-12 (December 7, 1988) (discussion of development of Chinese Walls in the securities laws).

⁷ See text accompanying notes 15 to 34 *infra* (reviewing Chinese Wall procedures for 23 integrated broker-dealers).

⁸ See Securities Exchange Act Release No. 17120 (September 4, 1980) 45 FR 60410 ("Adopting Release").

area of the firm.⁹ The Adopting Release discussed in some detail what elements are probative in determining "reasonableness under the circumstances." The Adopting Release noted the need for flexibility, given the diversity of broker-dealer firms, and commented that the procedures may include, but not be limited to, restrictions on retail and proprietary purchases and sales of securities, and restrictions on the flow of information.¹⁰ The Commission also discussed briefly the use and monitoring of restricted lists¹¹ and watch lists¹² to detect illegal trading.¹³

The Division recently re-examined the efficacy of Chinese Walls to deter insider trading.¹⁴ In 1987, the Division visited six major integrated New York broker-dealers to examine their Chinese Wall procedures and interview trading and compliance personnel as part of a comprehensive review of efforts by broker-dealers and SROs to detect and deter insider trading. The staff concluded that each of the firms used a combination of procedures designed to restrict the flow of information, complemented by restricted and watch list surveillance. The staff noted, however, that the terms used lacked consistent definition, and the procedures used also varied. Further, the staff found that record-keeping in connection with Chinese Wall procedures was inconsistent at best. The Division concluded that it had concerns about the effectiveness of Chinese Wall procedures at each of the firms it visited, and determined that the development of minimum standards would aid in the industry-wide improvement of broker-dealer Chinese Wall procedures. To that end, the Division recommended that firms memorialize in greater detail their procedures, and like-

wise improve the documentation, communication and recordkeeping associated with their Chinese Wall activities. Further, the Division raised concerns that the continuation of proprietary trading while a firm possessed material, nonpublic information remained a sensitive and critical issue. The Division also raised concerns that minimum standards for surveillance, such as watch lists, were not being maintained.

II. Current Broker-Dealer Chinese Wall Procedures

A. Description of Firms

In response to the legislative grant of rulemaking authority, the Division initiated a comprehensive review of broker-dealer Chinese Wall procedures. The Division requested written procedures and lists of recently completed mergers and acquisitions from 54 firms that are diverse as to size, business type, and geographic location. The Division chose 23 firms from that group for more extensive review and on-site interviews. Of that group, nine were New York firms, and the remaining represented the major regional brokerage houses.¹⁵ Division staff reviewed the procedures, surveillance, and documentation employed at the firms, and interviewed key compliance, legal, and investment banking personnel at each firm.

The staff examined the functions of six major areas within each firm: Investment Banking (which may include Corporation Finance or Mergers and Acquisitions), Research, Market Making, Retail Sales, Risk-Arbitrage, and Block Trading.¹⁶ Each firm in the sample provides some level of investment banking services for

⁹ 17 C.F.R. 240.14e-3(b).

¹⁰ See Adopting Release, *supra* note 8, at fn. 46. In particular, the Commission noted that any proprietary trading while the firm possessed material, nonpublic information would make more difficult the burden of proof as to the effectiveness of a firm's policies and procedures.

¹¹ A restricted list is a list of securities, maintained by a firm, in which proprietary, employee, and certain solicited customer transactions are restricted or prohibited.

¹² A watch list is a list of securities that, unlike restricted list securities, generally do not carry trading restrictions, but whose trading is subject to close scrutiny by the firm's compliance department. The watch list also differs from the restricted list in that its dissemination generally is limited.

¹³ The Commission has interpreted, and courts have reviewed, the issue of firm proprietary trading when in possession of material, nonpublic information. Although commenting that such trading should be restricted, the Commission never has stated that proprietary trading in such a context must be prohibited. See e.g., SEC v. First Boston Corp., Lit. Rel. No. 11092 (May 3, 1986) (release indicated that proprietary trading can occur when the trader has no knowledge of inside information and procedures are followed that prevent the trader from having or acting on inside information); letter from Larry Bergmann,

Assistant Director, Market Regulation, to Senator Edward Zorinsky, regarding David C. Myers (July 7, 1986) (noting in the context of Rule 14e-3 that "arbitrage activity by an investment banking firm is not *per se* proscribed even where the merger and acquisition department of that same firm has a role in the tender offer").

¹⁴ The Division also has examined Chinese Walls in the context of affiliations between retail trading firms and exchange specialists. In approving rule changes by the New York Stock Exchange ("NYSE") and the American Stock Exchange ("Amex") to remove prohibitions on specialist affiliations with integrated broker-dealers, the Commission relied on the maintenance of effective Chinese Wall procedures between the specialist, whose knowledge of the contents of the book could be useful, and the trading areas of the firm. See Securities Exchange Act Release No. 23768 (November 3, 1986), 51 FR 41183.

¹⁵ Given the proprietary nature of some of the information discussed, the Division has not identified any of the firms by name.

¹⁶ The Division did not see, nor did it conduct a specific review of, Chinese Wall procedures pertinent to high yield debt, or so-called junk bonds. Given that, at the small number of firms that have an active high yield area, one group may perform a variety of tasks normally segmented

clients, ranging from full merger and acquisition activity by some New York firms to limited underwriting of small, lightly traded corporations by some of the regional firms. Likewise, each firm maintains an active research department, providing reports for institutional or individual customers. With the exception of two New York broker-dealers, the remaining firms all have active retail sales and market making activities. Eight of the New York firms, and one regional firm, described their risk arbitrage trading as active. Only nine of the 23 firms engaged in proprietary trading of block orders as a customer facilitation. Division staff noted trends in a number of firms that linked the retail sales and research departments,¹⁷ as well as the risk arbitrage and block trading desks.

B. Policies and Procedures

1. Training

As noted, broker-dealer Chinese Wall procedures are designed theoretically either to prevent the inappropriate flow of material, nonpublic information or to aid in the detection of illegal trading based on such information. Each of the firms visited to some extent attempts to achieve employee awareness of prohibitions of the misuse of nonpublic information through employee training and the publication of policies concerning the misuse of such information. The staff found no consistency, however, concerning the level of sophistication of employee training. The majority of firms has no formal training procedures, but rely on a combination of internal memos, orientation materials, or certifications, acknowledging the receipt of firm policies concerning the confiden-

tiality of information and pledging compliance.¹⁸ Other firms vary the intensity and frequency of employee training on the basis of the sensitivity and responsibilities of the division. For example, certain firms have formal training for employees in the investment banking department but not in other areas. Other firms have extensive training for professional employees, but not for support or non-financial staff.¹⁹ Some firms use routine interaction, such as monthly meetings between the compliance department and sensitive areas, to communicate firm procedures. The most comprehensive training efforts consist of extensive education about firm policies and securities laws during an employee's orientation period, followed by supplemental training, seminars, and memoranda, reinforcing existing policies and keeping employees abreast of significant judicial, regulatory, and industry developments.²⁰

Likewise, the content of the training and supplemental procedures designed to segregate information between the various departments within a multi-service firm differ from firm to firm. In a number of firms, training consists of little more than a statement of policy concerning the confidentiality of information obtained in the course of employment, and prohibitions on trading based on such information. Other firms enforce a "need to know" policy concerning the inadvertent dissemination of information, and supplement this policy with a requirement that employees report all information obtained to an immediate supervisor. Firms often support their confidentiality policy with periodic seminars reinforcing the responsibility

(Footnote Continued)

in a multi-service firm, Chinese Walls designed to prevent the inappropriate flow of material, nonpublic information in a junk bond context is an important issue that the NYSE and NASD must address. Because the Division believes that a review of junk bond departments requires a separate review, the Division expresses no view in this report about the status or efficacy of policies and procedures in the high yield area.

¹⁷ In fact, brokers in a number of firms may only solicit customers for securities that have been recommended by the research department.

¹⁸ At one regional firm visited, employee training is the responsibility of each individual department head, who uses a variety of memoranda, seminars, and meetings. Employees receive a memorandum entitled "Treatment of Confidential Information and Personal Securities Transactions," which emphasizes the need to adhere to the firm policy concerning the confidentiality of client information. However, at other regional firms, the staff found no formal educational programs. Instead, procedures for employees often are written and communicated on a department by department basis.

¹⁹ According to compliance officials at one New York firm, only employees in the Corporation Finance Department receive any formal training. Other staff, whether

professional or clerical, have firm policies concerning the confidentiality of information communicated to them verbally by supervisors. At another major firm, the education of employees is accomplished through a series of memoranda, seminars, and lectures. All employees receive a copy of the firm's procedures at the commencement of employment. From that period on, however, the comprehensive on going educational efforts are directed only to employees in sensitive areas, such as Corporate Finance.

²⁰ One multi-service New York member firm uses several methods to attempt to sensitize employees to inadvertent disclosures of material, nonpublic information. A policy manual distributed to all personnel is intended to serve as permanent reference for employees with concerns regarding sensitive information. In addition, all employees receive memorandum, entitled "Guidelines for Business Conduct," which is updated periodically. Legal staff meets periodically with supervisors in each department for updates on relevant developments in the areas of Chinese Walls and inside trading. In addition to receiving the same training as other employees, the Investment Banking area receives supplemental training, including sessions consisting of a presentation on ethics, periodic memoranda updating and reiterating the contents of the policy manual, and an annual circular discussing confidentiality and security measures.

not to discuss nonpublic, market-sensitive information.

2. Employee Trading Restrictions

All firms attempt to reinforce their policies concerning employee misuse of confidential information by placing restrictions on employee trading activity. For example, almost all firms require employees to maintain accounts with the firm.²¹ Some smaller firms require pre-clearance of all employee trades, either by the compliance department or the individual supervisor. Other firms require pre-clearance for investment banking employees, who generally are restricted from trading in client securities.²² Restrictions on trading may take the form of holding periods of anywhere from 30 days to one year, or prohibitions on particular instruments or strategies, such as futures, naked options, or short selling. Firms also may take a somewhat more vague approach, counseling employees generally to trade only for investment or long-term purposes, and discouraging speculative or short-term trading. Restrictions also may be directed toward non-investment banking employees. A number of firms prohibit all employee trades in securities in which the firm is underwriter until all public clients are satisfied, and most firms prohibit employee or registered representative trading for two to five days in securities in which the firm has issued a research report.

3. Physical Barriers

All firms visited by the Division employ physical techniques to attempt to restrict the flow of information. Firms physically segregate their departments, employ procedures designed to restrict access to files, offices, and computers, and use code words or names when discussing sensitive projects. A minority of firms include periodic security checks of phone lines as part of their surveillance reviews.

²¹ This restriction generally extends to accounts of family members. There are a number of exceptions to this rule, including joint spousal accounts where the spouses work at different broker-dealers, accounts to trade instruments not offered by the broker-dealer (i.e., mutual funds or futures), and accounts over which the employee exercises no investment control. Generally, firms require employees with outside accounts to route trade confirmations and monthly account statements to their own head of compliance or the employee's immediate supervisor. See NYSE Rule 407(a)(1). Rule 407 requires member firms, when executing transactions for the account of an employee of another member firm, to obtain written approval from, and route reports and account statements to, the employer member firm.

²² Firms may require trade pre-clearance for investment banking employees and employees of certain other sensitive areas. At one firm, trade requests, either written or verbal, are checked against the firm's watch list and restricted list to ensure that the employee is not trading in a client's

4. Interdepartmental Procedures

a. Investment Banking - Research

All firms visited by the Division also have procedures designed to limit the necessary flow of information for business purposes. As a general rule, restrictions on interdepartmental communications are designed primarily to isolate the investment banking department from the various other departments within a firm.²³ For example, investment banking personnel often require information that can be provided by the firm's research, and to a lesser extent, sales departments. However, the process of obtaining the required information without effectively tipping confidential information to those departments presents a dilemma common to multi-service firms.

The investment banking department generally will attempt to elicit the needed information from the research analyst or retail employee without disclosing the purpose of the request. However, this technique often proves ineffective, because the form of the request itself becomes a tip to the employee.²⁴ Given the routine failure of that approach, firms may bring the employee with the necessary expertise or knowledge "over the wall," thereby making the employee, from a surveillance standpoint, a temporary member of the investment banking department possessing material, nonpublic information.

The procedure for bringing an employee over the wall varies from firm to firm. Generally, such decisions are made jointly by investment banking, compliance and research. Given the need for compliance to know the status of employees for surveillance purposes, significant contact between investment banking and other employees should have the prior approval of the head of compliance. However, in a number of firms, the investment banking department may make the decision unilaterally to bring an employee over the wall, and subsequently report

security. The head of Investment Banking supports the pre-clearance process by reviewing employee trades on a monthly basis.

²³ An obvious exception are Chinese Walls erected between specialist affiliates and upstairs firms. Although designed in part to prevent the flow of information between specialists and investment banking, adequate specialist Chinese Walls include restrictions on information flow to retail and proprietary trading.

²⁴ For example, if a research analyst knows that a company he or she regularly follows is rumored to be contemplating some type of merger or acquisition activity and also is an investment banking client of the firm, any question from investment bankers about the company or its related industry will likely lead the analyst to conclude that the company is working actively with the investment banking department.

the decision to compliance. In other firms, either the compliance department is not involved, or is informed but keeps no records of the action. The lack of interaction between investment banking and compliance or the failure to maintain records presents surveillance concerns. In light of the fact that employees in sensitive areas generally are subject to more stringent trading surveillance than other employees, compliance should have complete information to permit it to maintain adequate review of sensitive employee trading.

Certain firms employ a more centralized approach to the issue of the exchange of interdepartmental information by incorporating the head of research or a research-investment banking liaison into the small group to whom confidential information and client lists are disseminated. This approach provides a benefit at times by allowing research information to be obtained without tipping the research analyst, and by maintaining tighter control on interdepartmental communication.²⁵ However, such a procedure also is contrary to the stated preference of the majority of firms to keep the dissemination of active client lists and confidential information as restricted as possible.

b. Investment Banking - Proprietary Trading

In general, firm procedures designed to control the flow of information between investment banking and proprietary trading (risk arbitrage, market making and block trading) lack consistency. Firms with active proprietary trading are divided as to the amount of information reported from investment banking to individuals making investment decisions and the restrictions placed on the proprietary areas. Some firms maintain the integrity of the Chinese Wall between investment banking and risk arbitrage, allowing the trading desk to operate independently of investment banking information.

Other firms, however, will inform their risk arbitrage desk that either they have come into possession of material nonpublic information, or that they have been engaged by a client. These firms either require the risk arbitrage department to refrain from trading, or give the department a one-time opportunity to liquidate an existing position.²⁶

Block proprietary trading done to facilitate customer transactions is less likely to be restricted than risk arbitrage activity.²⁷ A number of firms noted that because block activity is not initiated by the firm and does not evidence any investment objective on behalf of the firm, it is unnecessary to restrict the activity. These firms also indicated that the sudden withdrawal by an active block trading desk in a particular security might serve to tip investors that the firm possessed information, generally presumed to be positive, about that security. However, a few firms with active block trading desks reported that such activity was restricted or discontinued.

Firm procedures governing the flow of information between investment banking and market making generally contain no restrictions on market making activity. Those firms that are over-the-counter market makers noted that withdrawing from the market in a company with whom the firm has had a previous investment banking relationship provided a clear tip about current inside information.²⁸ Firms that continue market making activity while in possession of confidential information either instruct their market makers to remain passive to the market, that is, to only take the contra side of unsolicited customer trades, or claim that such instructions are unnecessary because their market making activity always is passive. All firms interviewed indicated that their market makers do not make a practice of aggressively

²⁵ At one active New York Firm, all contacts between investment banking personnel and the Research Department concerning companies about which the firm possesses confidential information are coordinated by the Research Department Compliance Director. It is the responsibility of this person to ensure that the Chinese Wall between Research and Investment Banking is not compromised, and if a research analyst does become aware of material, non-public information from Investment Banking, that the proper compliance steps are taken, including placing the security under trade review or bringing the research employee over the wall.

²⁶ It may be important for the firm to liquidate its proprietary position because of the length of time a security may remain on the watch list. The lack of opportunity to liquidate may result in being locked into the position for a year or more.

²⁷ Block trading, or "equity trading," departments, act to facilitate the execution of large customer orders. Block traders will shop a large customer order with other member firms to attempt to find contra-side interest for the order. In

addition, the department often will take a proprietary position on the contra side of the customer's block in an attempt to facilitate a better execution. Without this additional liquidity, large orders would have to be worked against incoming order flow and slowly liquidated, potentially resulting in the execution of the large order at a variety of prices. In theory, block trading proprietary activity differs from risk arbitrage because the firm will not initiate positions in securities, but only establish the position as a reaction to the needs of a major customer.

²⁸ The nexus between underwriting activity by a firm's investment banking department and market making by the proprietary trading area is particularly acute in the context of regional broker-dealers and small issuers. In many situations, a firm will take a small issuer public with the understanding that the firm will remain a lead market maker in the stock. Given the nature of the close, multi-purpose relationship between firm and issuer, the withdrawal from the market making activity by the firm presents an obvious tip to outsiders.

building positions in their stocks or acting as a shadow risk arbitrage department.

c. Research Reports

As noted, the relationship between investment banking and research presents certain issues dissimilar to those raised in the investment banking-proprietary trading context. Research departments often cover companies with whom the investment banking department formerly or currently has a working relationship. In fact, it is not unusual for a research analyst to bring a client to the investment banker. The Division found that the issue of the publication of research reports while the investment banking department is in possession of material, nonpublic information resulted in a variety of procedural responses. All firms noted that the compliance department routinely reviews research reports prior to publication for a variety of reasons not directly connected to Chinese Wall procedures. The majority of firms reported that research reports routinely are pulled, or at least delayed, when the compliance or investment banking department, by virtue of its knowledge of confidential information, determines that the research recommendation is damaging or incorrect. Two firms interviewed maintain the division between research and investment banking, refusing to interrupt the publication of a report known to be in error because of its knowledge of confidential information. However, these firms did indicate that a research report would be delayed if the analyst inadvertently had uncovered or suggested accurate confidential information in the report.

Preventing the release of a report without tipping either the research analyst or the investing audience presents obvious concerns. Firms noted that they attempt initially an informal approach by delaying the report, without explanation either to the analyst or public. Given the limitations of this approach, firms generally will ultimately bring the analyst over the wall, and remove the analyst from public accessibility or instruct him or her to give neutral responses to public inquiries.²⁹

²⁹ The informal delay approach generally is more successful at larger firms, because these firms can stall the publication of a research report by saying that the compliance department reviewer is occupied with other projects accorded higher priority than the pending research report.

³⁰ Placement of a security on the watch list may occur at various stages in the investment banking process. Some firms remain vague as to the point in time, citing criteria such as "beyond the general proposal stage," or when the investment banking department determines that discussions have provided the firm with material information. Other firms use more concrete events to determine the timing of placement, such as the signing of a commitment or engagement letter, or after a potential target or buyer has been identified. The Division has concerns about the automatic

C. Review Procedures

Firms have implemented supporting procedures to prevent the inappropriate flow of confidential information by instituting routine review procedures for customer, employee, and principal trades. Trade reviews generally originate from a "watch" list, also called a "grey" list, and from a restricted list. Securities about which the investment banking department has confidential information are placed on one of the lists, thereby triggering a surveillance review by the firm's compliance department for suspicious activity.

Watch lists have limited distributions, and are designed to permit review without tipping firm or industry personnel as to the existence of a relationship between a broker-dealer and issuer. Generally, the contents of the watch list are known to the compliance or legal department (whichever is performing the surveillance function), the head of investment banking, select senior management, and sometimes the head of proprietary trading or research. Placement of stocks on the watch list differs from firm to firm, but generally placement occurs when discussions between the broker-dealer and client reach a point where clear business objectives have been identified.³⁰ The firms interviewed universally claimed that they are quick to place a security on the watch list, and will err on the side of caution when making the decision. A number of firms also noted that securities often remain on the watch list long after it is necessary, because decision-makers tend to focus only on the placement, and not removal, aspect of the process.³¹

Responsibility for placement of securities on a watch list involves some type of cooperative effort between compliance and investment banking. The head of investment banking generally makes the initial placement determination, either with consultation with the head of compliance or subject to compliance review and approval. A few firms noted that the decision-making responsibilities rested only with investment banking, with no consultation or review by compliance, and therefore no opportunity by

use of the engagement letter to trigger watch list reviews. Although it is appropriate in some instances, the engagement letter often is signed at a point well after material nonpublic information has been disseminated to the firm. Therefore, the Division favors case by case determinations, with reviews by the compliance department, instead of reliance on an automatic triggering event.

³¹ Certain firms hold periodic meetings between the investment banking and compliance departments to review watch list securities for the purpose of removing outdated entries. Given that the presence of a security on the watch list triggers certain surveillance efforts on the part of compliance, such meetings are an effective tool for properly focusing surveillance resources.

compliance to evaluate when the investment banking head is making a practice of waiting too long to place a security on the watch list. Most firms maintain a watch list log, recording when each security is added to or deleted from the list. Firms with small watch lists (the result of less active Investment Banking Departments) may disseminate the list each time it is amended. Major merger and acquisition firms disseminate the new list biweekly or monthly, because of the impracticality of re-issuing a constantly changing document.

Placement of a security on the watch list will trigger a number of surveillance activities and certain trading restrictions.³² In light of the goal of maintaining the confidentiality of the content of the watch list, broad public restrictions on employee or proprietary trading are considered to be counterproductive. However, some smaller firms restrict all employee and proprietary trades in watch list securities, while other firms only prohibit trading in watch list securities by employees in investment banking. However, the majority of firms leaves all non-proprietary trading in watch list securities unaffected, yet subject to trading reviews by compliance. The effect the placement of a security on the watch list has on proprietary trading differs from firm to firm and even department to department.

Surveillance activity concerning watch list securities constitutes the single most significant element of Chinese Wall review procedures. In smaller firms, every trade executed by the firm (customer, employee, proprietary, principal) is subject to review to examine for suspicious activity in watch list securities. Major firms, because of their larger trading volume, undertake a more sophisticated review, highlighting employee or proprietary trades in watch list securities. It is common practice for a firm initially to perform a retroactive review of trading, ranging from 5 to 30 business days. Following the initial review, the compliance department then reviews trading on a next day basis, identifying potentially suspicious employee trades and reviewing proprietary positions or activity.

Although employee trading in watch list securities generally is detected by the compliance department, trading will not be questioned unless a pattern develops or there is an obvious connection between the employee and a source of material, nonpublic information.³³

Some larger firms have developed sophisticated surveillance and exception review systems. Two major New York firms, for example, review trading in all securities whose volume exceeds a pre-determined percentage of total market volume, as well as reviewing employee, proprietary, and concentrated solicited customer trades. Moreover, one firm further divides its watch list into three sub-categories, each eliciting a different type of review. Securities are placed on the "grey" list when the Investment Banking Department is convinced that the information in its possession has little market impact, or when a merger client has yet to settle on a specific target or buyer. Placement of a security on the grey list does not trigger any trade restrictions or surveillance, but only focuses the firm's Director of Research Compliance to review research reports. Clients whose projects have developed to the stage that the information would have a market impact are placed on the "grey-arb" list, which has the effect of restricting arbitrage trading. Finally, issues that have market impact and merger or acquisition activity are placed on the "grey-M&A" list, which includes restrictions on proprietary trading and also triggers employee trading reviews.

Most firms that use watch list procedures also maintain a restricted list. More widely disseminated than the watch list, the restricted list is used when a deal is about to go public.³⁴ Given the nature of the restricted list, most firms use it less for Chinese Wall purposes than for other regulatory purposes in connection with an offering.³⁵ Certain smaller, regional firms continue to use the restricted list in place of the watch list, but such procedures reflect more a lack of significant merger and acquisition activity than a failure to maintain state of the art procedures.

³² See text accompanying notes 25 to 27 *supra* (discussing firm proprietary trading restrictions).

³³ A small number of regional firms noted that they break or cancel employee trades in watch list securities. Although these firms stated that they break the trades without explaining the reason to the employee, the Division believes that such action probably represents a clear tip to the employee.

³⁴ Most firms use their market information terminals (e.g. Quotron or Bridge Data) to disseminate the content of the restricted list. Restricted securities will be designated by "R" on the screen, thereby alerting the registered representative. Given the broad dissemination of the information, firms usually do not even maintain a pretext of secrecy about the content of the restricted list.

³⁵ Firms generally use the restricted list to ensure that trading in violation of Commission Rule 10b-6 does not occur. Firms will also use the restricted list to prevent violations of firm procedures concerning trading following the publication of research recommendations. Placement on the restricted list generally means no proprietary trading, no employee trading, and no solicited transactions. Firms generally break trades in restricted securities, unlike trading in watch list securities, which are reviewed for suspicious activity but rarely broken. Again, unlike watch list trades, trades in restricted list securities may result in a warning, while watch list trades are either dismissed or, in theory, result in insider trading investigations.

At least three major New York broker-dealers supplement their watch and restricted list surveillance with a so-called "rumor" list. The compliance department at these firms will place a security on the rumor list when a deal recently has been announced and some times even when the company is the subject of rumors of an impending transaction. Importantly, the list is not limited to issuers who are doing business with that specific firm. The firms perform an extensive retroactive review, usually covering the prior 30 business days, to determine if there was any suspicious activity in firm, employee, or customer accounts in the period prior to the announcement or circulation of the rumors.

III. Regulatory Issues

A. Summary of Findings

During the course of its review, the Division reached a number of conclusions about the status and effectiveness of broker-dealer Chinese Wall procedures. In particular, the Division has identified a number of policies and procedures that are necessary elements to an adequate firm Chinese Wall. Included in these minimum elements are (1) substantial control (preferably by the compliance department) of relevant interdepartmental communications; (2) the review of employee trading through the effective maintenance of some combination of watch, restricted, and rumor lists; (3) dramatic improvement in the memorialization of Chinese Wall procedures and documentation of actions taken pursuant to those procedures; and (4) the heightened review or restriction of proprietary trading while the firm is in possession of material, nonpublic information.

The Division also has concluded that oversight of broker-dealer Chinese Walls would best be effected by a thorough and aggressive SRO examination program with an active Commission oversight program. The NASD and NYSE have been pursuing pilot examination programs during recent months, and the Division expects the results of those programs shortly, so it may evaluate the effectiveness of the SROs' proposed programs. Finally, the Division, noting again the great diversity of broker-dealers, has concluded that, at this time, no aspect of current procedures require Commission rulemaking. However, if the Division finds either that neces-

sary improvements are not made through the SRO oversight programs or, that through experience, there exist deficiencies that are impossible to remedy by SRO action, we may revisit the issue of rulemaking. The findings of the Division are discussed in more detail below.

B. Current Status of Broker-Dealer Chinese Walls

In its review, the Division noted general improvement to the procedures employed by certain major New York broker-dealers. Unlike the findings of the 1987 review, these firms appear to be more cognizant of their responsibilities to prevent the misuse of material, nonpublic information, and are better equipped to perform effective surveillance over employee and proprietary activity.³⁶ By contrast, in this review the Division noted that smaller firms have less sophisticated procedures in place, perhaps because their surveillance responsibilities are less compelling. In fact, the Division noted that a number of smaller firms were beginning in early 1989 to formulate procedures as a response to the 1988 legislation, despite pre-existing regulatory incentives to have effective supervisory procedures in place.³⁷ At a number of these firms, the procedures submitted consist of little more than a statement concerning the confidentiality of information, supplemented by certain restrictions on trading. Written procedures explaining watch list or restricted list procedures or outlining review procedures were absent at a number of firms.

The Division believes that a number of major integrated broker-dealers have made commendable efforts to develop comprehensive Chinese Wall procedures. In particular, increased efforts to maintain the confidentiality of information through comprehensive training, more sophisticated methods of trading surveillance, and the development of new procedures such as rumor lists, all improve the ability of firms to combat the misuse of material, nonpublic information.

C. Minimum Standards

Although the Division believes that it is more appropriate to address the issue of dispositive evaluations of Chinese Wall adequacy through a detailed examination program, there are certain aspects of firm procedures without which a

³⁶ For example, the 1987 review criticized two New York firms for their lack of documentation. The 1989 review, however, found that both firms had responded to those criticisms, and the level of documentation at these firms were among the best seen by the staff.

³⁷ For example, Section 15(b)(4)(E) of the Act provides that a registered broker-dealer may avoid liability for failing to supervise a person who has committed a securities law violation if the firm has procedures, and a system for applying the procedures, which would be expected to detect and prevent such violations. Similarly, Commission Rule

14c-3(b) provides a safe harbor for proprietary trading when a firm is in possession of material, nonpublic information in connection with a tender offer, provided that the firm has adequate procedures to prevent the flow of information between departments. Further, in May 1988, the Commission approved amendments to NYSE Rules 342, 351, and 476, instituting supervisory and compliance obligations for NYSE member firms requiring review procedures for employee and proprietary trades to detect insider trading and other manipulative or fraudulent activity.

determination of adequacy would be difficult. For example, the maintenance of watch lists and restricted lists and the concomitant review of employee and proprietary trading are minimum elements. For NYSE member firms, the trading review already is mandated as a result of the recent amendments to NYSE Rules 342 and 351. In fact, the trade review section of the NYSE rules is very similar to Section 15(f) of the Act, requiring trade review procedures "reasonably designed to identify trades that may violate the provisions of the Securities Exchange Act of 1934, the rules under that Act or the rules of the Exchange prohibiting insider trading and manipulative and deceptive devices."³⁸ While watch and restricted list procedures probably are necessary to fulfill the requirements of the Act and NYSE rules, the NYSE should consider a requirement for firms to establish procedures, including, among other things, use of rumor lists, to review customer, employee, and proprietary trading on third party deals. Moreover, because not all broker-dealers are members of the NYSE, and are therefore not subject to the employee and proprietary trade review rules, the Division believes that the NASD should examine the effectiveness of its current, more general, regimen of supervisory rules, and report its conclusions to the Division.

The Division also believes that the procedures of the great majority of firms need to be structured and memorialized more than is current practice. As of February and March 1989, when the Division received submissions from the firms in response to its request for Chinese Wall procedures, those procedures to a great extent were a loose mixture of internal memoranda, excerpts from employee manuals, and certifications. During the on-site portion of the review, the Division was informed that some firms were rewriting their procedures in response to the promulgation of ITSFEA. The Division believes that this type of compilation and organization is a necessity at almost every firm. Procedures concerning interdepartmental communication, trade review and analysis, and investigation, that are designed to ensure compliance with ITSFEA must be formalized. Such restructuring will enable SRO or Commission examiners to determine whether the procedures in place are adequate.

Consistent with the Division's concern about written procedures, the documentation of efforts taken pursuant to Chinese Wall procedures must be improved. For example, the majority of firms fails to maintain adequate records of communication between the various departments. Smaller firms often do not maintain an entry log

for watch and restricted lists. Division staff also found that firms did not document daily trading reviews, and the subsequent review of potentially suspicious trading also lacked documentation. The Division notes that the failure to maintain documentation sufficient to re-create actions taken pursuant to Chinese Wall procedures will make reviews and determinations of the adequacy of procedures and compliance efforts exceedingly difficult. At the same time, the Division notes that imposition of documentation requirements should take into consideration the differences between the structures and activities of smaller firms and those of large multi-service firms.

The Division believes that the SROs must develop standards of documentation for their member firms. In light of the fact that SRO examiners will comprise the first line of review of firm procedures, the SROs will be in the best position to determine such standards. The Division therefore is requesting the NYSE and the NASD in the near future to circulate Notices to Members or Information Memoranda providing some guidance as to minimum levels of adequate documentation. If the Division finds that this approach does not achieve the desired level of document maintenance, it will consider the efficacy of promulgating specific recordkeeping requirements.

Moreover, each firm must have procedures concerning the restriction or review of proprietary trading while in the possession of material, nonpublic information.³⁹ Given the various types of firm proprietary trading, it is clearly not appropriate to recommend that all types of proprietary activity be prohibited when a firm comes into possession of material, nonpublic information. In certain cases, such as firm market making, such a requirement would be counterproductive to the goals of both confidentiality of information and market liquidity. However, in the context of risk arbitrage, the case for trading prohibitions is more compelling, because unlike either market making or block trading, the impetus for trading is neither passive or reactive, the benefits to the market are arguably fewer, and the opportunity for illegal profits is greater.

It is important to note that most of the historical discussion about proprietary trading, particularly risk arbitrage, while in possession of material nonpublic information centers on the use of restricted lists to limit such trading. The Division staff, however, found that there is no uniform procedure concerning risk arbitrage activity when the firm is in possession of material, nonpublic information. The firms surveyed

³⁸ See NYSE Rule 342.21(a).

³⁹ All the firms reviewed had at least some procedures concerning proprietary trading.

take a variety of positions, depending upon, among other factors, the type of risk arbitrage activity in which the firm is engaged. For example, three firms indicated that they do not permit their risk arbitrage desks to take positions in securities prior to a public announcement.⁴⁰ Accordingly, they noted that watch list-triggered trading restrictions probably are not necessary because they would not be trading in watch list securities.⁴¹ Other firms did not indicate that their risk arbitrage trading is limited to post-announcement activity. Within this category, procedural responses also differ. Three firms noted that they make a decision about whether to continue risk arbitrage at the time the security is placed on the watch list. Another firm attempts to prohibit such trading by informing the head of proprietary trading, who will effect the liquidation of any positions taken in watch list securities. Finally, one New York firm permits risk arbitrage activity with close monitoring by Compliance.

The Division remains concerned about risk arbitrage trading when the firm possesses material, nonpublic information. Given the difficulty in categorizing firm trading, and the possibility for profit, the Division believes that firms that freeze arbitrage activity when the security is placed on the watch list are choosing a prudent course. However, for firms that would choose to continue such activity in client securities, the burden of proving the reasonableness or adequacy of their internal procedures should increase dramatically, and that burden should only be met by a demonstration of the stringent review and documentation of firm trades.

The Division believes that the compliance department at multi-service firms must take the central role in the administration of the firms' Chinese Wall procedures. In particular, compliance must be informed and must maintain records of significant interdepartmental communications, such as bringing an employee over the wall. Further, compliance must take an interactive role with investment banking or other departments in the placement and removal of

issues from watch or restricted lists. Finally, compliance must be the area ultimately responsible for employee trade surveillance. Although useful as a supplement, employee trade review by supervisors who do not know the content of a watch list or do not have a sense of the firm's overall business position without concurrent surveillance by the compliance departments is inadequate.

Finally, the Division believes that firms should continue to place a high priority on training. Following the lead of a handful of major New York firms, all broker-dealers should commence comprehensive, interactive training programs, particularly for employees in sensitive areas, supplemented by routine updating and reinforcement of firm policies and applicable securities laws and regulations.

D. Oversight

Given that section 15(f) of the Act requires registered broker-dealers to have policies and procedures "reasonably designed . . . to prevent the misuse . . . of material, nonpublic information by such broker or dealer or any person associated with such broker or dealer," evaluations of "reasonableness" or "adequacy" may determine whether a firm is shielded from liability in an insider trading case. Therefore, the issue of oversight is an important one. The Division believes that member firm oversight is best effectuated by SRO examinations and regulation subject to Commission oversight.⁴² In fact, SRO review of member firm activity is central to the self-regulatory concept. Therefore, the Division currently is working with the SROs to develop examination modules to assist examiners in evaluating the effectiveness of broker-dealer Chinese Walls.

The NYSE and NASD act as the designated examining authority to the majority of registered broker-dealers. Therefore, the examination programs developed by these two SROs constitute the most important element in ensuring broker-dealer compliance with the statute.⁴³ In response, the NYSE and NASD are in the pro-

⁴⁰ The term "public announcement" is not always easily defined. News announcements, public discussions, or Commission filings such as a Schedule 13D (which would probably not trigger the placement of a security on the restricted list) all may constitute a public announcement.

⁴¹ Another firm noted, however, that it does freeze proprietary trading when a company is placed on the watch list. Further, each firm noted that there is extensive trade review of proprietary activity in watch list securities.

⁴² See S. Rep. No. 75, 94th Cong., 1st Sess. 22(1975). In the legislative history to the 1975 Amendments to the Securities Exchange Act, Congress cited the unique historical role of the self-regulatory system, including the relationship between broker-dealers and SROs. In particular, Congress noted, "In enacting the Exchange Act, the Congress balanced the limitation and dangers of permitting the

securities industry to regulate itself against the sheer ineffectiveness of attempting to assure [regulation] directly through the government on a wide scale. The result was a unique pattern of regulation combining both industry and government responsibility. Industry organizations, i.e. the exchanges and the NASD, are delegated governmental power in order to enforce . . . compliance by members of the industry with both the legal requirements laid down by the Exchange Act and ethical standards going beyond those requirements." *Id.* at 22-23.

⁴³ The Amex and Chicago Board Options Exchange serve as the designated examining authority for a smaller number of firms, and therefore must also develop examination programs. The Division anticipates that SRO examinations of Chinese Walls will be performed pursuant to the normal FINOP or sales practice cycle.

cess of completing pilot programs, during which each SRO is examining a number of firms to test the effectiveness of its examination modules.⁴⁴ Both SROs may consider possible amendments or alternatives to their current exam modules.⁴⁵

Further, because Section 15(f) is directed to "every registered broker or dealer," steps need to be taken to ensure that entities for whom Chinese Walls may not be necessary or useful (i.e. floor brokers or direct participation placement firms) are in conformity with the Act. The SROs recognize this concern, and, through the facilities of the Intermarket Surveillance Group ("ISG"), presently are developing a questionnaire that these firms must complete.⁴⁶ It is anticipated that the accuracy of the questionnaires or surveys will be reviewed as part of the routine examinations of these firms.

The Commission also will supplement the oversight activities of the SROs. As part of their routine examinations of registered broker-dealers, the Commission's regional offices will conduct a preliminary review to evaluate firm compliance with ITSFEA, which will include an examination of Chinese Wall written procedures. Further, the Division and regional offices are establishing a committee which will develop a detailed checklist specifically tailored for regional office examinations of broker-dealer Chinese Wall. To aid in the development of the checklist, and to assist in oversight, Division staff has accompanied regional office personnel on their first two Chinese Wall examinations. Finally, following the completion of the NASD and NYSE pilot programs, the Division will include the SROs' Chinese Wall activities as a high priority in its routine oversight inspection program. Through these actions, the Division believes it can stay aware of Chinese Wall activity both at the broker-dealer and SRO levels, and be prepared to amend its position concerning rulemaking should it find that either level of implementation or review is unsatisfactory.

⁴⁴ The NYSE examined the Chinese Wall procedures for 41 firms in connection with its pilot program. The NASD conducted examinations of 19 firms using its pilot module. The NYSE also requested, and is in the process of reviewing, the written procedures for all its member firms.

⁴⁵ As presently constructed, the NYSE exam module includes a "question bank" of 62 questions concerning confidentiality of information, employee trading, trade review and other supervisory and compliance issues, along with a "matrix" which instructs examiners as to those questions which are pertinent to each firm or area within a firm. The NASD module consists of questions and requests for documentation divided into five areas, supplemented by questionnaires asking firms to provide clients, employee lists, and a copy of their written procedures. The NASD has indicated that it currently is considering comments from its examiners, and anticipates that a revised module should be complete by the first quarter of 1990.

E. Need For SEC Rulemaking

The Division has concluded from its comprehensive review of broker-dealer Chinese Walls that Commission rulemaking, at this time, is not a necessary response to the promulgation of ITSFEA or the current state of firm procedures. While the procedures in place vary widely in scope and comprehensiveness, the Division believes that the firms reviewed generally had adequate procedures in place. In this connection, we are concerned that SEC rulemaking standards risk being unnecessarily rigid. The type and formality of Chinese Wall procedures must vary with the size and activities engaged in by each firm. Moreover, we do not wish to discourage experimentation and new ideas by firms to revise their Chinese Wall procedures over time.

As discussed above, there are areas in which we believe improvement can be made in many firms' procedures. We believe these improvements can best be obtained, however, through an aggressive examination program, perhaps aided where necessary by limited SRO regulation. Accordingly, the Division will not commence any rulemaking projects. Instead, it will focus its resources on monitoring closely in its oversight capacity the development of SRO examination procedures for reviewing member firm Chinese Walls, and working with the SROs and the securities industry in addressing the issues noted in this reports particularly the need for better documentation of Chinese Wall compliance.⁴⁷

IV. Conclusion

In its comprehensive review of broker-dealer Chinese Walls, the Division of Market Regulation found policies and procedures varying widely in scope and sophistication. While identifying certain areas of concern, the Division has concluded preliminarily that generally these systems are well conceived and conscientiously executed. Despite this promising overall view, the Division identified certain deficiencies com-

⁴⁶ The ISG recently submitted a draft of the questionnaire to the Division for its comments. In its current form, the document clarifies what types of firms may use the questionnaire to satisfy the requirements of § 15(f). The questionnaire consists of a number of forms which require members and employees to certify knowledge of the requirements concerning material, nonpublic information, and requires that they list contacts with insiders of publicly traded companies and accounts in which they have an interest. See letter from Jeffrey B. Schroer, Chicago Board Options Exchange, to Julio A. Mojica, Assistant Director, Division of Market Regulation, dated October 26, 1989.

⁴⁷ The Division notes that it has participated in an ongoing, productive dialogue with the Securities Industry Association which, in response to the ITSFEA legislation, has formed an ad hoc group to work with the staff on these issues.

mon to the procedures of most firms, and outlined certain practices that are necessary elements of an adequate Chinese Wall.

Further, the Division determined that necessary improvements to the efficient operation of broker-dealer Chinese Walls would best be effectuated, not by Commission rulemaking, but by vigorous self-regulatory examination programs,

supplemented by Commission oversight. However, the Division will continue to monitor closely the self-regulatory programs, and Chinese Walls generally, and will reconsider a recommendation of Commission rulemaking should it become dissatisfied with either of these programs.

[§ 84,521] Credit by Brokers and Dealers; Accommodation of Settlement and Clearance of Foreign Securities.

Board of Governors of the Federal Reserve System. March 21, 1990. Docket No. R-0675 in full text.

Broker-Dealers—Credit—Foreign Securities.—Regulation T has been amended to allow for the marginability of certain foreign securities and to accommodate settlement and clearance of transactions in foreign securities. The changes take effect April 30, 1990.

See § 22,201, "Exchange Act—Margin; Borrowing Restrictions" division, Volume 2.

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board is adopting amendments to Regulation T to permit marginability of certain foreign securities and to accommodate settlement and clearance of transactions in foreign securities.

EFFECTIVE DATE: April 30, 1990.

FOR FURTHER INFORMATION CONTACT: Laura Homer, Securities Credit Officer, or Scott Holz, Attorney, Division of Banking Supervision and Regulation, (202) 452-2781. For the hearing impaired only, Telecommunications Service for the Deaf, Earnestine Hill or Dorothea Thompson, (202) 452-3544.

SUPPLEMENTARY INFORMATION: The proposal to amend Regulation T to accommodate foreign securities transactions was published for public comment in the Federal Register on October 10, 1989 (54 Fed. Reg. 41454). Sixteen comments were received. All supported the Board's proposal, although there were requests for clarification or modification of specific aspects of the proposed amendments. In light of the comments received, the Board has decided to adopt the amendments as proposed with some modifications.

Foreign debt securities. The proposal to make marginable foreign debt securities that have an original issue amount of \$100,000,000 if the issue is rated in one of the two highest rating categories and is not in default at the time of the extension of credit was well-received by the commenters. A definition of "foreign security" has been added in response to comments to make clear that Eurobonds issued by United States corporations are eligible on the same basis as debt securities issued by foreign corporations. A request to add another category of

marginable bonds for securities issued by companies reporting under the Securities Exchange Act is not being adopted at this time in order that experience with the original proposal may be gained. The Board has also declined to adopt a lower principal amount than that originally proposed, as well as restrictions on marginability relating to the market in which the bonds trade or their salability to U.S. persons.

Foreign equity securities. The Board proposed that foreign equity securities that met certain criteria would be marginable after certification by a U.S. self-regulatory organization, such as the New York Stock Exchange, which has adopted procedures for determining eligibility under criteria adopted by the Board. The NYSE commented that it does not believe that it is appropriate for the Exchange itself to certify the eligibility of stocks for the list of foreign margin stocks. The NYSE has agreed, however, to submit a list of proposed foreign margin stocks to the Board based on certification of the securities' eligibility by at least two of its members who meet certain described standards. The Board agrees with the procedure suggested by the NYSE and the amendment is being revised accordingly. These new marginable foreign equity securities, which will be designated "foreign margin stock" (rather than "world-class securities," as previously proposed) will become marginable when their names appear on a list of marginable foreign equity securities that will be published in conjunction with the Board's regular quarterly List of Marginable OTC Stocks.

Other comments concerning the proposal to make certain foreign equity securities marginable were extremely wide-ranging and showed little consensus. The Board is adopting the criteria originally proposed with one exception. The requirement that foreign margin equity securi-

Exhibit 2

Energy

Deutsche Bank



October 3, 2000

Enron Corp.

Maintaining Buy Rating, Credit Update

Maintaining Buy Rating: We continue to maintain a Buy rating on the bonds of Enron Corp. (ENE) based on the company's large and diversified mix of global energy and energy-related businesses, fast-growing unregulated activities, core regulated U.S. transportation and distribution segment, proven risk management expertise, demonstrated balance sheet/ratings commitment and solid financial flexibility. ENE remains a member-in-good-standing of our 6-B energy focus list.

Corporate Makeover: Over the past few years, ENE's corporate makeover has accelerated and changed strategic course, as the company (led by President and COO Jeff Skilling) has endeavored to shed its historical asset/capital-intensive business model and reposition itself as an information-based (albeit still energy-focused) growth company. Since 1998, ENE has been aggressively expanding its wholesale energy activities (i.e., commodity trading), while concomitantly moving into the retail energy arena (i.e., energy outsourcing for commercial and industrial customers) and entering the global telecommunications business (i.e., bandwidth management and broadband delivery).

Balance Sheet Management: To date, ENE management has toed a very responsible financial line despite a changing business mix and an active M&A posture and we expect this dynamic to continue going forward. The company has sought to further offset the incremental operating risk posed by its growing unregulated activities by deleveraging financially, using a combination of outright debt reduction (mainly asset sales-driven), non-recourse (i.e., structured) borrowings (many refinancing-related), frequent equity issuance and steady earnings retention.

Peer Group Comparison: ENE stands out versus its diversified natural gas pipeline peers (both U.S. and non-U.S.), both in terms of its strategic business focus and operating size/breadth as well as its financial strength and adeptness.

Ratings Trajectory: Based on the company's recent balance sheet strengthening moves, Moody's finally upgraded ENE's senior unsecured rating from Baa2 (where it had been stuck since September 1989) to Baa1 in March 2000. Standard & Poor's last upgraded ENE from BBB to BBB+ back in December 1995. While we view the company's high-BBB ratings as stable for the moment, we note that the longer-term goal of ENE is to ultimately make the jump to the 2-A ratings category.

Relative Value: We view ENE as a core holding among the diversified natural gas pipelines. Generally speaking, we prefer to play the ENE name through its myriad structured corporate deals, given the significant spread pick-up (roughly 40-60 bp at present) and *de minimus* incremental credit risk characterizing most issues in this category. Specifically, we recommend ENE's Marlin Water Trust, Osprey Trust, Yosemite Securities Trust I and recently-floated Enron Credit Linked Notes Trust issues.

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Corporate Makeover

Since commencing operations as a pure regulated U.S. natural gas transmission company, ENE's business mix has been steadily changing. In its early evolutionary phase during the late 1980s and early 1990s, this business transition involved expanding and diversifying the company's energy activities, mainly by adding an unregulated component (i.e., natural gas and power marketing) to its portfolio and increasing its international exposure (i.e., Europe, Latin America and Asia Pacific). However, over the past few years, ENE's corporate makeover has accelerated and changed strategic course, as the company (led by President and COO Jeff Skilling) has endeavored to shed its historical asset/capital-intensive business model and reposition itself as an information-based (albeit still energy-focused) growth company.

Toward this end, since the late 1990s, ENE has been selling off physical assets to free up capital for investment in higher-return (and increasingly non-energy) unregulated areas. With regard to the former, the company spun off its majority-owned E&P subsidiary, EOG Resources, Inc., in August 1999 and expects to close on the previously-announced \$2.1 billion sale of wholly-owned Portland General Electric Company (PGE) by year-end 2000 or early 2001. With regard to the latter, since 1998, ENE has been aggressively expanding its wholesale energy activities (i.e., commodity trading), while concomitantly moving into the retail energy arena (i.e., energy outsourcing for commercial and industrial customers) and entering the global telecommunications business (i.e., bandwidth management and broadband delivery). Over the same period, ENE also made an initial foray into the global water business through Azurix Corp. (AZX), which went public in June 1999 and is currently two-thirds controlled (both directly and indirectly) by ENE. Thus far, AZX has underperformed the expectations of ENE management and investors alike, as the company has repeatedly missed with its privatization bids and quarterly earnings guidance. In the wake of the recent resignation of AZX Chairman and CEO (and long-time ENE Board member), Rebecca Mark, we expect ENE to exit the global water business and sell off AZX (either in whole or in pieces) over the near term.

ENE's business mix is currently organized around four core segments: transportation and distribution; wholesale energy; retail energy; and broadband services. ENE's transportation and distribution business includes the company's North American interstate natural gas transmission network (32,000 miles of mainline pipe over four major systems), its crude oil transportation activities in the U.S. and Canada (EOTT Energy Partners, L.P.) and its electricity transmission and distribution operations in Oregon (PGE).

ENE's wholesale energy category includes its established global energy commodity marketing operations. The company recently introduced an Internet-based trading platform

(EnronOnline.com) offering trading in more than 800 products—mainly energy-related commodities (e.g., crude oil, natural gas and electricity) and financial instruments (e.g., weather derivatives and price/risk hedges)—with ENE serving as the counterparty in each trade. Introduced in November 1999, the ENE web-based transaction system has thus far exceeded management's growth expectations, handling over 200,000 transactions with an aggregate gross value in excess of \$100 billion through June 30, 2000. Since the beginning of the year, the company has been migrating its U.S.-leading energy trading business to its eCommerce platform. Currently, roughly 60% of ENE's wholesale transactions are conducted on-line, which is up from 25% in December 1999. Going forward, ENE's goal is to use its Internet-based trading platform to market and deliver a growing array of non-energy (e.g., pulp and paper, steel and metals, chemicals) and non-conventional (e.g., data storage, logistics, settlements) commodities.

ENE's retail energy business provides full energy outsourcing services to commercial and industrial customers in the U.S. and U.K. to help companies manage their energy requirements and reduce their total energy costs. Recent management contracts inked by the company have included: Quebecor Inc. (\$1.0 billion, 10 years); Starwood Hotels & Resorts Worldwide, Inc. (\$1.0 billion, 10 years); Sonoco Inc. (\$210 million, 10 years); The Prudential Insurance Company of America (\$180 million, 10 years); and Rich Products Corporation (\$130 million, 11 years).

In broadband, ENE is currently developing a 14,500-mile high-capacity, global fiber-optic network, the Enron Intelligent Network (EIN), with a distributed server architecture to provide services to the broadband market including bandwidth management and intermediation and high-quality content services. On the infrastructure front, as of June 30, 2000, ENE had deployed 525 large-capacity servers and completed 5,325 route miles on the EIN, mainly throughout the U.S., with plans to link in Tokyo and several major European cities during the current year. On the content front, ENE announced the signing of a 20-year exclusive agreement (valued at upwards of \$1.0 billion) with Blockbuster Inc. (BBI) on July 19 to deliver a Blockbuster entertainment (i.e., movies) on-demand service via the EIN, using high-speed digital subscriber lines (DSL) provided by SBC Communications Inc., Verizon Communications, Qwest Communications International Inc., Covad Communications Group Inc., Telus Corporation and ReFlex Communications Inc. to connect the last mile to consumers' television (80% of the U.S. DSL market).

As a result of the recent shift in its strategic focus—with its reliance on relationships rather than asset ownership—ENE's operating risk profile has increased in recent years. The company's current business mix—with its unregulated bias, increasingly-important wholesale energy component and heightened market-making aspect—is characterized by thin-



Figure 1. ENE: Operating Statistics (Year ended December 31)

(\$ in millions)	1996	1997	1998	1999	6M00
Total physical volumes (bbl/day)					
Natural gas	9,237	11,037	12,714	15,527	25,080
Crude oil and NGL	1,507	1,577	3,570	6,160	5,591
Electricity	1,648	5,255	11,024	10,742	13,613
	12,392	17,870	27,308	32,429	44,284
Natural gas volumes marketed (bbl/day)	8,693	10,577	12,155	14,952	24,554
% U.S.	80.5	72.4	61.0	60.1	65.3
% Canada	16.2	21.4	28.7	29.4	22.4
% Europe and Other	3.3	8.2	10.3	10.5	12.3
Natural gas transport volumes (bbl/day)	544	460	559	575	526
Total electricity sales (thousand MWh)	14,840	22,511	28,313	31,871	19,076
% Residential	23.1	14.9	25.1	23.2	20.1
% Commercial	23.2	16.0	24.0	23.2	19.1
% Industrial	13.6	9.6	12.6	14.0	12.6
% Wholesale	40.1	59.5	38.4	39.6	48.2
Average variable power cost (Mills/KWh)	13.1	17.2	15.6	19.5	23.8
Retail electricity customers (thousands)	668	685	704	719	726
Electricity volumes marketed (thousand MWh)	60,150	191,846	402,372	392,094	247,748
% U.S.	100.0	99.9	99.9	97.0	91.6
% Europe and Other	0.0	0.1	0.1	3.0	8.4
Financial settlements (notional) (bbl/day)	35,259	49,062	75,266	99,337	147,247

Notes: Some numbers may not total due to rounding.

Source: Company reports, Deutsche Bank

ner overall margins (3.6% consolidated EBITDA margin in the second quarter of 2000, versus 13.8% in all of 1994), placing a premium on volume growth and risk management. However, on the former front, ENE has been very successful in growing the scope of its operations since 1995, as seen in Figure 1. On the latter front, while somewhat of a black box for investors, ENE's risk management track record now stretches back to the 1980s. Given the increasing volatility of the global commodity markets in which ENE traffics, the company has had ample opportunity to have been caught off-sides since the mid-1990s. However, over the past five years, ENE has not experienced a significant negative quarterly earnings surprise related to its wholesale energy (i.e., trading) activities, proving in our mind the adequacy of the company's established monitoring systems and internal controls and ENE management's risk tolerance.

Figure 2 shows a segment breakdown of ENE's cash flow between January 1, 1995 and June 30, 2000. As the table highlights, ENE's wholesale energy operations have comprised an increasing share of consolidated EBITDA and capital expenditures over the past several years, while its nascent retail energy and broadband businesses remain in investment mode at this point. Over the 1995-1999 period, wholesale energy activities accounted for \$3.6 billion or roughly 44% of ENE's consolidated EBITDA of \$8.3 billion. During the first half of 2000, this figure jumped to 61%. In terms of investment spending, ENE has allocated approximately 50% of its total capital expenditures (excluding acquisitions) to its wholesale energy business (which also in-

cluded broadband services prior to 2000) since 1998, up from roughly 20-25% over the 1995-1997 period.

That being said, ENE's transportation and distribution segment continues to serve as a stable source of positive free cash flow to fund growth elsewhere. Such regulated U.S. activities generated aggregate free cash flow of \$986 million over the 1998-1999 period. Consequently, while the company has been moving in an asset-free business direction of late, it remains to be seen whether ENE will ever part company with its natural gas transmission business, given that its pipeline network forms both the company's psychological core as well as its credit backbone. Were ENE to ultimately jettison its pipeline segment—either outright or through a less-than-arm's-length disposal—such a transfiguring transaction would need (we think) to result in substantial concomitant debt reduction in order to maintain ENE's current high-BBB senior unsecured ratings. Using recent pipeline M&A trades (e.g., Consolidated Natural Gas Company/Dominion Resources, Inc., Columbia Energy Group/NiSource Inc., The Coastal Corporation/EI Paso Energy Corporation) as a cash flow multiple guide (10-12x EBITDA), we estimate the current market value of ENE's transportation operations (excluding PGE) at roughly \$8-10 billion.

Balance Sheet Management

To date, ENE management has toed a very responsible financial line despite a changing business mix and an active

Figure 2. ENE: Segment Cash Flow (Year ended December 31)

(\$ in millions)	1995	1996	1997	1998	1999	6M00
Operating Profit (EBIT)						
Transportation and Distribution	279	337	398	562	551	303
Wholesale Energy	291	287	375	890	889	483
Retail Energy	0	0	(105)	(124)	(81)	7
Broadband	0	0	0	0	0	(10)
E&P	240	205	185	133	66	0
Corporate and Other	(192)	(139)	(164)	(73)	(182)	(92)
	618	690	690	1,378	1,243	691
DD&A and Exploration Expense						
Transportation and Distribution	82	66	160	253	246	125
Wholesale Energy	132	138	133	195	294	160
Retail Energy	0	0	7	31	29	18
Broadband	0	0	0	0	0	11
E&P	295	340	380	436	262	0
Corporate and Other	2	19	22	33	68	50
	511	563	702	948	919	364
EBITDA						
Transportation and Distribution	361	403	558	815	797	428
Wholesale Energy	423	425	509	1,075	1,183	643
Retail Energy	0	0	(88)	(93)	(52)	25
Broadband	0	0	0	0	0	1
E&P	535	545	565	569	328	0
Corporate and Other	(199)	(120)	(142)	(40)	(84)	(42)
	1,129	1,253	1,392	2,326	2,162	1,055
Capital Expenditures (CAPEX) (1)						
Transportation and Distribution	127	175	337	310	316	80
Wholesale Energy	152	136	318	706	1,216	523
Retail Energy	0	0	36	75	64	30
Broadband	0	0	0	0	0	219
E&P	464	540	626	690	226	0
Corporate and Other	34	13	75	124	541	157
	777	864	1,392	1,905	2,363	1,009
EBITDA-CAPEX						
Transportation and Distribution	234	228	221	505	481	348
Wholesale Energy	271	289	191	369	133	120
Retail Energy	0	0	(134)	(168)	(116)	(5)
Broadband	0	0	0	0	0	(216)
E&P	71	5	(61)	(121)	102	0
Corporate and Other	(224)	(133)	(217)	(164)	(635)	(199)
	352	389	0	421	(201)	46
Memo: Acquisitions	206	687	1,227	2,299	1,438	1,350

Notes: (1) Excludes acquisitions. Some numbers may not total due to rounding.

Source: Company reports, Deutsche Bank

M&A posture and we expect this dynamic to continue going forward. The company has sought to further offset the incremental operating risk posed by its growing unregulated activities by deleveraging financially, using a combination of outright debt reduction (mainly asset sales-driven), non-recourse (i.e., structured) borrowings (many refinancing-related), frequent equity issuance and steady earnings retention.

Figure 3 provides a financial summary for ENE as of June 30, 2000. At the mid-year 2000 point, ENE's total debt tallied \$12.6 billion (including preferred stock issued at the subsidiary level), the equivalent of 53.9% of total capitalization and 6.0x LTM EBITDA of \$2.1 billion. While somewhat stretched in the context of the company's current Baa1/BBB+ ratings, this situation should prove temporal as ENE's leverage measures are set to improve sharply over the near term. Pro forma for the above-noted pending sale of PGE to Sierra Pacific Resources—which will relieve ENE of approximately \$1.0 billion of balance sheet borrowings, while

bringing in \$2.1 billion of cash for further debt reduction purposes—ENE's book leverage should drop to the 45-50% range, while its total debt/EBITDA should move back down to the 3-4x area.

Moreover, ENE's financial flexibility is further bolstered by its high-priced common stock, which has enjoyed a stellar New Economy-esque run of late and is currently trading at roughly 60-65x 2000E earnings. As seen in Figure 4, ENE's equity price has jumped by some 90% since January 1, 2000, which compares with respective increases of 65%, 12% and 2% for the S&P Natural Gas Index (SPNGAS) (largely ENE-driven), S&P Energy Composite Index (SPENRC) and S&P 500 Index (SPX) over the same year-to-date period.

Peer Group Comparison

ENE stands out versus its diversified natural gas pipeline peers (both U.S. and non-U.S.), both in terms of its strategic

Figure 3. ENE: 6/30/00 Financial Summary

Issue	Coupon (%)	Maturity Date	Size (\$mm)	Current Ratings	Call Price (\$)	Next Call Date
Senior unsecured bonds	6.750	8/1/09	200	Baa1/BBB+	NC	NC
Senior unsecured bonds	6.950	7/15/28	250	Baa1/BBB+	NC	NC

(\$ in millions)	2Q 6/30/99	3Q 9/30/99	4Q 12/31/99	1Q 3/31/00	2Q 6/30/00	FYE 12/31/98	FYE 12/31/99	LYM 6/30/00
Summary Income Statement Data								
Total revenues	9,572.0	11,835.0	10,973.0	13,145.0	16,866.0	31,260.0	40,112.0	52,839.0
Cost of sales	8,347.0	10,489.0	9,675.0	11,888.0	15,324.0	26,381.0	34,761.0	47,326.0
Gross profit	1,325.0	1,346.0	1,348.0	1,257.0	1,562.0	4,879.0	5,351.0	5,513.0
DD&A expense	238.0	225.0	194.0	172.0	192.0	822.0	870.0	793.0
Exploration expense	20.0	10.0	(6.0)	0.0	0.0	121.0	49.0	4.0
SG&A expense	836.0	706.0	940.0	813.0	951.0	2,553.0	3,189.0	3,410.0
Operating profit (EBIT)	233.0	405.0	220.0	272.0	419.0	1,378.0	1,243.0	1,316.0
Interest expense (1,2)	194.0	206.0	138.0	179.0	217.0	627.0	732.0	740.0
Impairment of oil and gas properties	0.0	441.0	0.0	0.0	0.0	0.0	441.0	441.0
Other income (expense)	213.0	518.0	212.0	312.0	151.0	122.0	1,058.0	1,199.0
Pre-tax income	252.0	278.0	294.0	410.0	353.0	878.0	1,128.0	1,333.0
Income tax expense (benefit)	30.0	(14.0)	35.0	72.0	64.0	175.0	104.0	152.0
Earnings (loss) before extraordinary items	222.0	290.0	259.0	338.0	289.0	703.0	1,024.0	1,176.0
Extraordinary items	0.0	0.0	0.0	0.0	0.0	0.0	(131.0)	0.0
Net income	222.0	290.0	259.0	338.0	289.0	703.0	893.0	1,176.0
Preferred stock dividends	19.0	19.0	24.0	20.0	21.0	170.0	66.0	84.0
Net income available to common	203.0	271.0	235.0	318.0	268.0	533.0	827.0	1,092.0
Margin Analysis								
Gross margin (%)	13.7	11.4	12.3	9.6	9.3	15.6	13.3	10.4
EBIT margin (%)	2.4	3.4	2.0	2.1	2.5	4.4	3.1	2.5
Net margin (%)	2.3	2.5	2.4	2.6	1.7	2.2	2.2	2.2
EBITDA margin (%)	5.1	5.4	3.7	3.4	3.6	7.4	5.4	4.0
Summary Cash Flow Data								
EBITDA (\$)	489.0	640.0	408.0	444.0	611.0	2,326.0	2,162.0	2,103.0
Capital expenditures (CAPEX) (4)	(824.0)	(1,403.0)	(401.0)	(1,510.0)	(849.0)	(4,204.0)	(3,801.0)	(4,163.0)
EBITDA-CAPEX	(335.0)	(763.0)	70.0	(1,066.0)	(238.0)	(1,878.0)	(1,639.0)	(2,060.0)
Interest expense (1,2)	(194.0)	(206.0)	(138.0)	(179.0)	(217.0)	(627.0)	(732.0)	(740.0)
Free cash flow	(529.0)	(969.0)	(131.0)	(1,245.0)	(455.0)	(2,505.0)	(2,371.0)	(2,800.0)
Summary Balance Sheet Data								
Cash and cash equivalents	286.0	316.0	288.0	466.0	718.0	111.0	288.0	718.0
Total debt (\$)	9,080.0	9,593.0	9,152.0	11,271.0	12,596.0	8,358.0	9,152.0	12,596.0
Stockholders' equity	9,206.0	9,345.0	9,570.0	10,140.0	10,769.0	10,480.0	9,570.0	10,769.0
Coverage/Leverage Measures								
EBITDA/Interest expense (x)	2.5	3.1	3.0	2.5	2.8	3.7	3.0	2.8
EBITDA-CAPEX/Interest expense (x)	(1.7)	(3.7)	0.1	(6.0)	(1.1)	(3.0)	(2.2)	(2.8)
Total debt % Total capitalization	49.7	50.7	48.9	52.6	53.9	54.3	48.9	53.9
Net debt % Total capitalization	48.9	49.8	48.1	51.6	52.4	53.9	48.1	52.4
Total debt/LTM EBITDA (x)	3.8	4.0	4.2	5.7	6.0	3.6	4.2	6.0
Net debt/LTM EBITDA (x)	3.7	3.9	4.1	5.5	5.6	3.5	4.1	5.6
Liquidity								
Cash and cash equivalents	6/30/00			Debt Maturities (\$)			6/30/00	
Bank revolver availability (7)	718.0			2000			2,001.0	
Current debt maturities	883.0			2001			569.0	
Cash excess (deficit)	(1,495.0)			2002			432.0	
Capitalization	115.0			2003			494.0	
Bank revolver (\$3.3 billion facility)	0.0			Enterprise Value			6/30/00	
Senior secured and unsecured bonds	9,564.0			Avg. common share price (\$ (7/1/99-6/30/00)			54.20	
Other debt (\$)	3,032.0			Period-end shares outstanding (mm)			738.9	
Total debt	12,596.0			Common market value			40,049.8	
Preferred stock	1,127.0			Preferred stock at book value			1,127.0	
Common stock	9,642.0			Market-adjusted equity			41,176.8	
Total book capitalization	23,365.0			Net debt			11,878.0	
Total debt % Market capitalization	23.4			Enterprise value (EV)			53,054.8	
				EV/LTM EBITDA (x)			25.2	

Business Description

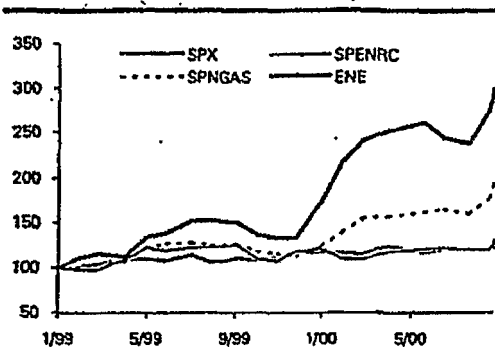
Headquartered in Houston, ENE is a diversified U.S. natural gas pipeline company operating worldwide across the energy spectrum. Since divesting its E&P segment in 1999, the company's current mix of regulated and unregulated businesses includes: transportation and distribution (natural gas and electricity); wholesale energy (primarily Internet-based commodity trading); retail energy (mainly commercial and industrial); and broadband services.

Notes: (1) Net of capitalized interest; (2) Includes dividends on preferred stock of subsidiary; (3) Before exploration expense; (4) Includes acquisitions; (5) Includes preferred stock of subsidiary; (6) As of 12/31/99; (7) Reduced for outstanding commercial paper. Some numbers may not total due to rounding.

Source: Company reports, Deutsche Bank



Figure 4. ENE: Relative Stock Market Performance
(weekly, 12/31/98=100, 1/1/99-9/30/00)



Source: Bloomberg L.R., Deutsche Bank

business focus and operating size/breadth as well as its financial strength and adeptness. With regard to the former, while many of its industry counterparts have also pursued unregulated paths of late, ENE's asset-free approach, Internet-based success and non-energy push are all unmatched at this point, although copiers/competitors may develop down the road. With regard to the latter, Figure 5 shows how ENE stacks up financially against its similarly-rated pipeline peers at this juncture. Notable in this financial comparison is ENE's significantly-larger top-line and thinner margins, as well as the relative strength of its credit measures—particularly in a U.S. context—which is mainly reflective of the company's active balance sheet management in recent years. Going forward, we expect many of ENE's pipeline peers to follow the company's lead on the non-recourse/structured financing front.

Figure 5. ENE: Comparative Financial Statistics

(\$ in millions)	ENE	BG	CGP	EPG	KMI	TRP	WMB
Senior Unsecured Ratings	Baa1/BBB+	A2/A	Baa2/BBB	Baa2/BBB	Baa2/BBB-	A2/A-	Baa2/BBB-
Summary Financial Data (LTM 6/30/00)							
Total revenues	52,839	8,114	10,594	13,039	1,917	9,899	9,714
EBITDA	2,103	3,826	1,568	1,733	483	1,824	1,981
Interest expense (1)	740	658	366	516	249	788	835
Capital expenditures (2)	4,163	1,731	2,174	2,809	158	940	4,622
Cash and cash equivalents	718	575	66	129	27	292	460
Total debt (3)	12,596	9,778	6,896	6,469	3,868	10,060	11,509
Stockholders' equity	10,769	14,199	4,224	3,293	1,718	3,831	5,992
EBITDA margin (%)	4.0	47.2	14.8	13.3	25.2	18.4	20.4
EBITDA/Interest expense (x)	2.8	5.8	4.3	3.4	1.9	2.3	2.4
EBITDA-CAPEX/Interest expense (x)	(2.8)	3.2	(1.7)	(2.1)	1.3	1.1	(3.2)
Total debt % Total capitalization	53.9	40.8	62.0	66.3	69.2	72.4	65.8
Net debt % Total capitalization	52.4	39.3	61.8	65.8	69.1	71.8	64.8
Total debt/EBITDA (x)	6.0	2.6	4.4	3.7	8.0	5.5	5.8
Net debt/EBITDA (x)	5.6	2.4	4.4	3.7	8.0	5.4	5.6

Peer Group Ticker Legend: BG = BG Group plc; CGP = The Coastal Corporation; EPG = El Paso Energy Corporation; KMI = Kinder Morgan, Inc.; TRP = TransCanada PipeLines Limited; WMB = The Williams Companies, Inc.

Notes: (1) Includes dividends on preferred stock of subsidiary and trust preferred securities; (2) Includes acquisitions; (3) Includes preferred stock of subsidiary and trust preferred securities. Some numbers may not total due to rounding.

Source: Company reports, Deutsche Bank

Ratings Trajectory

Based on the company's recent balance sheet strengthening moves, Moody's finally upgraded ENE's senior unsecured rating from Baa2 (where it had been stuck since September 1999) to Baa1 in March 2000. Standard & Poor's last upgraded ENE from BBB to BBB+ back in December 1995. While we view the company's high-BBB ratings as stable for the moment, we note that the longer-term goal of ENE is to ultimately make the jump to the 2-A ratings category.

ENE has clearly demonstrated its ratings commitment over the past decade, but particularly over the past two flux-filled years. At this point, the company essentially vets all of its significant M&A and balance sheet decisions with Moody's and Standard & Poor's before proceeding to ensure a no-worse-than-neutral ratings outcome. Moreover, we note that ENE has a substantial amount of direct and indirect (i.e., structured corporate) debt outstanding in the market, providing a further ratings tether for the frequently-issuing ENE. In addition, given the counterparty nature of its increasingly trading-oriented business mix, the company also has a clear operating/competitive incentive to safeguard its rating status. Lastly, were ENE to prospectively divest its pipeline operations, we would expect the company to work closely with the rating agencies to guard against a negative ratings reaction. As noted above, we believe that significant hand-in-hand deleveraging would serve to shore up the company's upper 6-B ratings in the wake of such a meaningful M&A event and, depending on the actual numbers, could potentially push the company's ratings up into the long-coveted 2-A category. Although a pipeline sale-related upgrade will be a difficult one for ENE to finesse with the rating agencies, we note that if the company does ultimately



Figure 6. ENE's Comparative Trading Levels

Issuer	Ticker	Issue Type	Coupon (%)	Maturity Date	Currency	Size (mm)	Current Ratings	Bid Spread (bp)
Enron Corp.	ENE	Sr. Unsec.	6.625	10/15/03	\$	100	Baa1/BBB+	108
Enron Corp.	ENE	Sr. Unsec.	4.375	4/8/05	€	400	Baa1/BBB+	151
Enron Corp.	ENE	Sr. Unsec.	6.625	11/15/05	\$	250	Baa1/BBB+	123
Enron Corp.	ENE	Sr. Unsec.	8.750	8/1/09	\$	200	Baa1/BBB+	168
Enron Corp.	ENE	Sr. Unsec.	6.950	7/15/28	\$	250	Baa1/BBB+	190
Marlin Water Trust	ENE	Sr. Sec.	2.090	12/15/01	\$	1,024	Baa1/BBB	134
Osprey Trust	ENE	Sr. Sec.	6.375	1/15/03	€	315	Baa2/BBB	175
Osprey Trust	ENE	Sr. Sec.	7.787	1/15/03	\$	750	Baa2/BBB	175
Osprey Trust	ENE	Sr. Sec.	8.310	1/15/03	\$	1,400	Baa2/BBB	178
Yosemite Securities Trust I	ENE	Sr. Unsec.	8.250	1/15/04	\$	750	Baa1/BBB+	198
Enron Credit Linked Notes Trust	ENE	Sr. Unsec.	8.000	8/15/05	\$	500	Baa1/BBB+	181
British Gas Finance Inc.	BG	Sr. Unsec.	6.625	6/1/18	\$	300	A2/A	180
The Coastal Corporation	CGP	Sr. Unsec.	6.375	2/1/09	\$	200	Baa2/BBB	173
El Paso Energy Corporation	EPG	Sr. Unsec.	6.750	5/15/09	\$	500	Baa2/BBB	173
Kinder Morgan, Inc.	KMI	Sr. Unsec.	6.900	3/1/08	\$	300	Baa2/BBB-	188
TransCanada PipeLines Limited	TRP	Sr. Unsec.	6.490	1/21/09	\$	400	A2/A-	170
Williams Holdings of Delaware, Inc.	WMB	Sr. Unsec.	6.500	12/1/08	\$	250	Baa2/BBB-	173

Notes: Indicative trading levels as of 10/3/00.

Source: Bloomberg L.P., Deutsche Bank

go completely asset-free, it will need to be higher-rated. Under such a scenario, ENE would essentially be repositioning itself as the equivalent of a broker-dealer, the average ratings for which industry currently approximates high-A.

Relative Value

We view ENE as a core holding among the diversified natural gas pipelines. Figure 6 provides the current secondary market context for the company's bonds. Generally speaking, we prefer to play the ENE name (and all of the pipelines, for that matter) through its myriad structured corporate deals, given the significant spread pick-up (roughly 40-

60 bp at present) and *de minimis* incremental credit risk characterizing most issues in this category. Specifically, we recommend ENE's Marlin Water Trust (which is insulated from the above-noted AZX problems), Osprey Trust (which was recently tapped for an incremental \$750 million tranche and €315 million tranche), Yosemite Securities Trust I and recently-floated Enron Credit Linked Notes Trust issues. All four structured bonds are rated either equal to, or within one notch of, ENE's Baa1/BBB+ senior unsecured ratings. Moreover, we note that the company's shorter-dated Marlin Water Trust and Osprey Trust issues, by virtue of their backing by ENE convertible preferred stock, also offer fixed income investors a play on the company's high-flying common stock (NYSE: ENE, \$86.125 at the close on October 3).

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ANARPT002098

Exhibit 3

DATE: November 9, 1999

TO: Investment Banking
Capital Markets
Syndicate
Global Lending
Relationship Managers
All Other SSB & Citibank Private Side Employees

FROM: Michael Carpenter
Victor Menezes

RE: Information Sharing

Attached is a memo that the Legal and Compliance Departments prepared concerning sharing client information between Citibank and SSB professionals. It is very important that you review and understand the attached policies. We would like to emphasize the importance of sharing client information in order to enhance the quality of our client coverage and service. Equally important to our franchise as well as our regulatory compliance program is maintaining the confidentiality of material non-public client information and strategic objectives. This requires that we employ the "need to know" principle with regard to material non-public client information very strictly. In that regard the attached policies and procedures attempts to strike a balance between these two important goals and to provide examples of situations that are likely to recur and suggested responses. Because circumstances can vary, we urge you to contact senior business managers and local legal and compliance professionals to review situations as they arise. Also attached are the general "Wall Crossing Policy and Procedures" and "Confidential Information" memoranda that are relevant to the subject.

Should you have any questions regarding this policy, call Dave Fenimore or Wendy Beer in New York at (212) 816-0898 and (212) 816-5940, respectively, or the local Chinese Wall person.

CITINEWBY 00195138

STATEMENT REGARDING INFORMATION SHARING

SUMMARY

In the ordinary course of business, the commercial and investment bankers (CRB and Investment Banking Division) have access to confidential non-public information. These are referred to as "Private Side" businesses. A permanent "Chinese Wall" prohibits the sharing of confidential information obtained by the private side of Citigroup's with the public side of its business (sales, trading and research). These rules are intended to prevent securities law violations such as insider trading by limiting access to confidential non-public information. Confidential customer information from the private side may only be shared with a public side employee when that employee is "brought over the wall" in a rigorous approval and notification process initiated by the private side, administered by the compliance department and requiring the approval of senior management on the public side. Situations in which a public side employee is brought over the wall are quite limited. Most typically, they involve a research employee participating in due diligence for a securities offering by a customer or assessing a merger, acquisition or other strategic situation that a customer is considering. Salesmen and traders are seldom brought over the wall, because the capital markets groups are on the private side and are able to give bankers and their issuer customers market color, making it generally unnecessary to then place salesmen or traders over the wall. However, there may be circumstances when we do bring salesmen and traders, with legal and business approval, which can result in full trading restrictions. The Chinese Wall separates the private side from the public side without regard to legal entity. Sales, trading and research, whether at Citibank, SSB or any other legal entity are on the public side of the wall.

There are no permanent Chinese Walls or barriers on the private side of the business (investment bankers, relationship managers, capital markets and private side product professionals) that would prohibit sharing information. However, Citigroup policy, broker-dealer regulations and in many instances confidentiality agreements, require that we safeguard our customers' confidential information. In general, confidentiality agreements or Citigroup policy would limit the sharing of information within the private side by the "need to know" principle. The more sensitive the non-public information, the higher the burden of demonstrating "need to know" when sharing the information with others on the private side. Discussed below are guidelines for dealing with highly sensitive information and other confidential information within the private side. Because judgment is usually required in applying these principles, illustrations of practical applications follow the general discussion.

GENERAL PRINCIPLES

The "need to know" principle governs sharing of confidential information among and between employees and divisions on the private side. Confidential information regarding highly sensitive transactions is also regarded as confidential information about a company (including earnings, material developments, etc.). However, because special procedures apply to highly sensitive transactions, the two categories are discussed separately.

Highly Sensitive Transactions

Material non-public information regarding customer transactions - information which if publicly known might affect the price of public securities - is highly sensitive and subject to special compliance procedures. In the context of such highly sensitive transaction information, the private side and deal team notifies compliance of the professionals on the team and compliance keeps a log of people who are working on or have knowledge of the transaction. This treatment is designed to protect the customer's information, and, in some cases, temporary "walls" are created to separate one private side deal team from another where Citigroup may be representing customers with conflicting interests in the sensitive transaction (e.g. multiple bidders). The deal team procedure is meant to ensure that only those who need to know about the transaction to execute the client's strategy, manage the client relationship and approve or track the deal from an internal risk management, legal or compliance standpoint will have access to the information. See the memorandum attached entitled "Confidential Information" (October 7, 1998) which explains the "need to know principle" and other relevant principles in more detail.

Other Confidential Customer Information

In addition to any constraints in confidentiality agreements, it is Citigroup's policy that confidential information received from a customer will be used only in connection with Citigroup's relationship with the customer. The "need to know" principle governs the sharing of such information on the private side. Whenever a Citigroup private side professional obtains confidential customer information, he or she should share that information with other private side professionals only to the extent that they need to know the information to execute the customer's strategy or business purpose, develop a product to address the customer's needs, manage the customer relationship or comply with internal credit, legal or compliance requirements. Citigroup may represent customers who have or may in the future have, conflicting interests. In order to maintain Cit's ability to effectively serve these customers, we need to be careful in sharing information, where possible, not to conflict other private side professionals regarding existing or prospective engagements.

ILLUSTRATIONS APPLYING THE PRINCIPLES

Underwritings

When SSB is the underwriter of debt or equity securities for a customer, SSB performs due diligence regarding the customer to assure that all material information regarding the issuer is available to potential investors and to establish a defense to potential liability for material misstatements and omissions. If SSB failed to access confidential information in the possession of an affiliate that impeached the customer's disclosures, it could be a fatal flaw to SSB's due diligence defense. Relevant information in the possession of all areas of Citigroup is attributable to SSB as underwriter. In this situation, it will be necessary for the SSB team working on the underwriting to have access to all relevant confidential customer information within SSB, Citibank or other affiliates. If a business unit with relevant information is subject to a confidentiality agreement, which would not permit the sharing of information, the customer must consent to the sharing of the information in order for SSB to proceed with the underwriting. Neither a confidentiality agreement nor any internal "wall" will protect SSB from having such relevant information attributed to it.

Sensitive Strategic Information

If an SSB banker is engaged on a highly sensitive merger or acquisition, there will typically be no need to share the information broadly within SSB, Citibank or other affiliates. However, situations may arise that justify sharing the information, from a "need to know" perspective, with other private side Citigroup professionals. For instance, a senior calling officer (e.g., a Citibank vice-chairman) or senior relationship manager may need to know about the strategic assignment to manage the overall relationship as part of a calling effort. The strategic assignment could require financing where discussions with lending professionals or capital markets professionals are necessary to facilitate the customer's strategic goal. In determining whether or not the information needs to be shared, commercial considerations, including possible representation of customers who may have conflicting interests, should be taken into account. For example, a Global Relationship Bank industry head may have sufficient need to know of a sensitive transaction involving one of his or her customers in order to coordinate a senior calling effort. However, if there is a substantial possibility that the industry head may become involved in the transaction with another customer with conflicting interests, it may be wise to exclude the industry head from the first customer's deal team and find some other way of effectively coordinating the calling program. Private side bankers and relationship managers need to take particular care in this regard in sharing highly sensitive transaction information. Of course, any necessary sharing of such information will be subject to the applicable compliance procedures.

Exhibit 4

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OFFERING MEMORANDUM



PRIMARK
CORPORATION
Osprey Trust
Osprey I, Inc.

\$750,000,000 7.797% Senior Secured Notes due 2003
€315,000,000 6.375% Senior Secured Notes due 2003

The 7.797% Senior Secured Notes due 2003 (the "Dollar Senior Notes") and the 6.375% Senior Secured Notes due 2003 (the "Euro Senior Notes" and, together with the Dollar Senior Notes, the "New Senior Notes") being offered hereby (the "Offering") will be issued by Osprey Trust, a Delaware statutory business trust ("Osprey"), and Osprey I, Inc., a Delaware corporation and a wholly-owned subsidiary of Osprey (the "Co-Issuer" and, together with Osprey, the "Issuers"). The closing of the Offering is expected to occur concurrently with, and the Offering is conditioned upon, the closing of an offering of \$50 million face amount of Osprey Trust Certificates (the "New Trust Certificates" and, together with the New Senior Notes, the "New Securities"), representing beneficial ownership interests in Osprey. The New Trust Certificates are not being offered hereby. Osprey will make a capital contribution of the proceeds from the sale of the New Securities to Whitewing Associates LP, a Delaware limited partnership ("Whitewing LP") in exchange for an increase of Osprey's pledged limited partner interest in Whitewing LP. Whitewing LP will use the proceeds from such contribution to, among other things, purchase, from time to time, certain assets owned or originated by Enron Corp., an Oregon corporation ("Enron").

The New Senior Notes will bear interest from October 5, 2000 (the "Closing Date") at the rate of (i) 7.797% per annum, payable semi-annually in arrears on each January 15 and July 15, in the case of the Dollar Senior Notes and (ii) 6.375% per annum, payable annually in arrears on each January 15, in the case of the Euro Senior Notes, in each case, commencing January 15, 2001. The principal of the New Senior Notes will be due and payable on January 15, 2003 (the "Maturity Date") to the extent not redeemed or repaid prior thereto. The New Senior Notes may be redeemed at the option of the Issuers, in whole or in part, at any time, at a redemption price equal to the sum of the accrued and unpaid interest to the date of redemption plus the greater of (i) 100% of the outstanding principal amount of such New Senior Notes and (ii) the sum of the present values of the remaining scheduled payments of principal and interest thereon discounted to the date of redemption (a) on a semi-annual basis at the applicable US Treasury yield plus 50 basis points, in the case of the Dollar Senior Notes, or (b) on an annual basis at the applicable European Government Yield plus 50 basis points, in the case of the Euro Senior Notes. Upon the occurrence of certain Osprey Note Trigger Events, the New Senior Notes will be redeemed, on a pro rata basis, on the dates fixed by the Indenture Trustee at a redemption price equal to the accrued and unpaid interest to the date of redemption plus 100% of the outstanding principal amount of the New Senior Notes plus all other amounts due and owing to the Noteholders under the Indenture. See "Description of the New Senior Notes — Redemption."

The New Senior Notes will represent senior secured limited recourse obligations of the Issuers ranking pari passu in right of payment with the Issuers' \$1.4 billion 8.31% Senior Secured Notes due 2003 (the "Existing Senior Notes" and, together with the New Senior Notes and any Additional Notes outstanding, the "Senior Notes"). The Senior Notes will be secured, on a first priority basis, by: (i) all of the rights of Osprey, excluding Excepted Rights, under the Participation Agreement, the Whitewing LLC Agreement, the Whitewing Partnership Agreement, the Remarketing Agreement, the Enron Agreement and certain other Transaction Documents; (ii) Osprey's member interest in Whitewing Management LLC and Osprey's pledged limited partner interest in Whitewing LP; (iii) certain accounts established pursuant to the Indenture, all amounts credited to such accounts and all investments of such amounts pursuant to the applicable provisions of the Indenture and (iv) all proceeds of the conversion, voluntary or involuntary, of any of the foregoing into cash, instruments, securities or other property (the "Security for the Senior Notes"). See "Description of the New Senior Notes — Security for the Senior Notes." Holders of the Senior Notes will have recourse only to the Security for the Senior Notes for payments due thereon. The Senior Notes are not guaranteed by, and the Security for the Senior Notes does not represent a guarantee by, Enron.

Except as otherwise described herein, upon the occurrence of an Osprey Note Trigger Event, the Indenture Trustee will exercise its rights under the Remarketing Agreement to cause the Share Trustee to liquidate the mandatorily convertible junior preferred stock, Series B, no par value, of Enron (the "Enron Mandatorily Convertible Preferred Stock") held by the Share Trust through a mandatory remarketing arrangement and apply the proceeds against the repayment of the Senior Notes. The Indenture Trustee will cause the Share Trustee to exercise the Share Settlement Agreement to the extent of any shortfall. See "Description of the New Senior Notes — Osprey Note Trigger Events and Remedies" and "Description of Certain Transaction Documents — Description of the Share Settlement Agreement." Upon the occurrence of an Osprey Note Trigger Event and subject to certain limitations described herein, the Indenture Trustee also may, or at the direction of the holders of at least 25% of the then outstanding principal amount of the Senior Notes or the holders of at least 25% of the then outstanding face amount of the Osprey Trust Certificates will, foreclose on Osprey's pledged limited partner interest in Whitewing LP and cause the sale of Whitewing LP's assets, including the Whitewing Assets. See "Description of the New Senior Notes — Limitations on Remedies of the Indenture Trustee."

Application has been made to list the New Senior Notes on the Luxembourg Stock Exchange.

See "Risk Factors" beginning on page 14 for a discussion of certain matters that should be considered in connection with an investment in the New Senior Notes.

THE NEW SENIOR NOTES HAVE NOT BEEN AND WILL NOT BE REGISTERED UNDER THE UNITED STATES SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), OR ANY STATE SECURITIES LAWS AND MAY NOT BE OFFERED OR SOLD EXCEPT PURSUANT TO AN EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT AND APPLICABLE STATE SECURITIES LAWS. ACCORDINGLY, THE NEW SENIOR NOTES ARE BEING OFFERED HEREBY ONLY (A) TO "QUALIFIED INSTITUTIONAL BUYERS" (AS DEFINED IN RULE 144A UNDER THE SECURITIES ACT ("RULE 144A")) IN RELIANCE ON THE EXEMPTION FROM THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT PROVIDED BY RULE 144A AND (B) OUTSIDE THE UNITED STATES TO CERTAIN PERSONS IN RELIANCE UPON REGULATION S UNDER THE SECURITIES ACT ("REGULATION S"). PROSPECTIVE PURCHASERS ARE HEREBY NOTIFIED THAT SELLERS OF THE NEW SENIOR NOTES MAY BE RELYING ON THE EXEMPTIONS FROM THE PROVISIONS OF SECTION 5 OF THE SECURITIES ACT PROVIDED BY RULE 144A AND REGULATION S. FOR A DESCRIPTION OF CERTAIN RESTRICTIONS ON REALES OR TRANSFERS OF THE NEW SENIOR NOTES, SEE "NOTICE TO INVESTORS."

	Per Senior Note(1)	Total
Price to Investors of Dollar Senior Notes	100.000%	\$750,000,000
Price to Investors of Euro Senior Notes	99.905%	€314,700,750

(1) Enron has agreed to indemnify the Initial Purchasers against, and to provide contribution with respect to, certain liabilities under the Securities Act. See "Plan of Distribution."

The New Senior Notes are offered by Donaldson, Lufkin & Jenrette Securities Corporation, Deutsche Bank Securities Inc., Credit Suisse First Boston Corporation, Lehman Brothers and UBS Warburg LLC (the "Initial Purchasers"), subject to prior sale, when, as and if delivered to and accepted by the Initial Purchasers, and subject to certain conditions. It is expected that delivery of the New Senior Notes will be made in book-entry form through the facilities of The Depository Trust Company ("DTC") (in the case of the Dollar Senior Notes) and the Euroclear System ("Euroclear") or Clearstream Banking, société anonyme ("Clearstream") (in the case of the Euro Senior Notes) against payment therefor in immediately available funds on or about October 5, 2000.

Joint Bookrunning Managers

Donaldson, Lufkin & Jenrette

Deutsche Banc Alex. Brown

Co-Managers

Credit Suisse First Boston

Lehman Brothers

UBS Warburg LLC

September 28, 2000

It is expected that delivery of the New Senior Notes will be made against payment therefor on or about the date specified in the last paragraph of the cover page of this Offering Memorandum (the "Offering Memorandum"), which will be the fifth business day following the date hereof (such settlement cycle being herein referred to as "T+5"). Purchasers of the New Senior Notes should note that trading of the New Senior Notes on the date hereof or the next succeeding business day may be affected by the T+5 settlement. See "Plan of Distribution."

The New Senior Notes will be available initially only in book-entry form. The Issuers expect that the New Senior Notes sold pursuant to Rule 144A or pursuant to Regulation S will be issued in the form of Global Notes. Upon issuance, the Global Notes will be deposited with (i) the Indenture Trustee as custodian for DTC and registered in the name of DTC or its nominee, in the case of the Dollar Senior Notes or (ii) Deutsche Bank AG London, as common depositary (the "Common Depositary") for Euroclear and Clearstream and registered in the name of Euroclear or Clearstream or its nominee, in the case of the Euro Senior Notes. Beneficial interests in such Senior Notes will be shown on, and transfers thereof will be effected through, (i) records maintained by DTC and its participants, in the case of the Dollar Senior Notes, and (ii) in accordance with the rules and procedures for Euroclear and Clearstream, in the case of the Euro Senior Notes. Until the expiration of the Distribution Compliance Period, beneficial interests in the Senior Notes issued pursuant to Regulation S may be held only through Euroclear or Clearstream, unless transferred to a person that takes delivery through a Rule 144A Global Note in accordance with the certification requirements described herein. In certain circumstances, Definitive Notes will be issued. See "Description of the New Senior Notes — Depository Procedures."

IN CONNECTION WITH THE OFFERING, THE INITIAL PURCHASERS MAY OVER-ALLOT OR EFFECT TRANSACTIONS WHICH STABILIZE OR MAINTAIN THE MARKET PRICE OF THE NEW SENIOR NOTES AT LEVELS ABOVE THOSE WHICH MIGHT OTHERWISE PREVAIL IN THE OPEN MARKET. FOR A DESCRIPTION OF SUCH ACTIVITIES, SEE "PLAN OF DISTRIBUTION." SUCH STABILIZING, IF COMMENCED, MAY BE DISCONTINUED AT ANY TIME.

THE INFORMATION CONTAINED AND INCORPORATED BY REFERENCE IN THIS OFFERING MEMORANDUM HAS BEEN FURNISHED BY THE ISSUERS AND ENRON AND THEY CONFIRM THAT SUCH INFORMATION IS TRUE AND ACCURATE IN ALL MATERIAL RESPECTS. THE INITIAL PURCHASERS MAKE NO OTHER REPRESENTATION OR WARRANTY AS TO THE ACCURACY OR COMPLETENESS OF ANY SUCH INFORMATION.

THIS OFFERING MEMORANDUM CONTAINS OR INCORPORATES BY REFERENCE SUMMARIES, BELIEVED TO BE ACCURATE, OF CERTAIN TERMS OF CERTAIN DOCUMENTS, BUT REFERENCE IS MADE TO THE ACTUAL DOCUMENTS, COPIES OF WHICH WILL BE MADE AVAILABLE UPON REQUEST, FOR THE COMPLETE INFORMATION CONTAINED THEREIN. ALL SUCH SUMMARIES ARE QUALIFIED IN THEIR ENTIRETY BY THIS REFERENCE AND SUCH COMPLETE INFORMATION.

NO PERSON IS AUTHORIZED IN CONNECTION WITH ANY OFFERING MADE HEREBY TO GIVE ANY INFORMATION OR TO MAKE ANY REPRESENTATION NOT CONTAINED OR INCORPORATED BY REFERENCE IN THIS OFFERING MEMORANDUM, AND, IF GIVEN OR MADE, SUCH OTHER INFORMATION OR REPRESENTATION MUST NOT BE RELIED UPON AS HAVING BEEN AUTHORIZED BY THE ISSUERS, ENRON, ANY OF THE OTHER PARTIES TO THE TRANSACTIONS OR THE INITIAL PURCHASERS. THE INFORMATION CONTAINED HEREIN IS PROVIDED AS OF THE DATE HEREOF AND SUBJECT TO CHANGE OR AMENDMENT WITHOUT NOTICE. NEITHER THE DELIVERY OF THIS OFFERING MEMORANDUM AT ANY TIME NOR ANY SUBSEQUENT SALE OF THE NEW SENIOR NOTES OFFERED HEREBY SHALL, UNDER ANY CIRCUMSTANCES, CREATE ANY IMPLICATION THAT THERE HAS BEEN NO CHANGE IN THE INFORMATION SET FORTH OR INCORPORATED BY REFERENCE HEREIN OR IN THE AFFAIRS OF THE ISSUERS, ENRON OR ANY OF THE OTHER PARTIES TO THE TRANSACTIONS SINCE THE DATE HEREOF.

AVAILABLE INFORMATION

Enron files annual, quarterly and special reports, proxy statements and other information with the Commission. Enron's Commission filings are available to the public over the Internet at the Commission's web site at <http://www.sec.gov>. You may also read and copy any document Enron files at the Commission's public reference rooms in Washington, D.C., New York, New York and Chicago, Illinois. Please call the Commission at 1-800-SEC-0330 for further information on the public reference rooms and their copy charges. Reports, proxy statements and other information concerning Enron can also be inspected and copied at the offices of the New York Stock Exchange at 20 Broad Street, New York, New York 10005, the offices of the Chicago Stock Exchange at 120 South LaSalle Street, Chicago, Illinois 60603, and the offices of the Pacific Stock Exchange at 301 Pine Street, San Francisco, California 94014. The Commission allows Enron to "incorporate by reference" the information it files with them, which means that Enron can disclose important information by referring to those documents. The information incorporated by reference is an important part of this Offering Memorandum, and information that Enron files later with the Commission will automatically update and supersede this information. The documents listed below and any future filings made by Enron with the Commission under Sections 13(a), 13(c), 14, or 15(d) of the Exchange Act until all of the New Senior Notes are sold are hereby incorporated by reference.

- Enron's Annual Report on Form 10-K for the fiscal year ended December 31, 1999;
- Enron's Quarterly Reports on Form 10-Q for the quarters ended March 31, 2000 and June 30, 2000;
- Enron's Current Report on Form 8-K filed May 19, 2000; and
- Enron's capital stock description set forth in Enron's Registration Statement on Form 8-B filed on July 2, 1997.

A copy of these filings may be obtained at no cost, by written or oral request to Enron at its principal executive offices: Secretary Division, Enron Corp., 1400 Smith Street, Houston, Texas 77002; telephone: (713) 853-6161. Such copies will also be available at the office of Deutsche Bank Luxembourg S.A., the Luxembourg paying and transfer agent, free of charge at any time.

None of the Issuers, Egret, Peregrine, Whitewing Management LLC, Whitewing LP or the Share Trust is currently subject to the informational requirements of the Exchange Act. Consequently, none of the Issuers, Egret, Peregrine, Whitewing Management LLC, Whitewing LP or the Share Trust has been or will be required to file reports, proxy statements or other information with the Commission. The Issuers have agreed that for so long as any Senior Notes remain outstanding, the Issuers will furnish to the holders and to prospective transferees of the Senior Notes, upon their request, the information required to be delivered pursuant to Rule 144A(d)(4) under the Securities Act. The Issuers shall provide to Enron, to the Indenture Trustee and to holders of the Senior Notes, within 60 days after the end of the first, second and third fiscal quarters of each fiscal year, unaudited consolidated balance sheets and statements of income and cash flows for such fiscal year and the portion of the fiscal year ending with such fiscal quarter, and shall provide to the Indenture Trustee and to holders of the Senior Notes, within 120 days after the end of each full fiscal year, audited consolidated financial statements. See "Description of the New Senior Notes — Covenants — Reports."

Each purchaser of the New Senior Notes shall be furnished with a copy of this Offering Memorandum and any related amendments or supplements to this Offering Memorandum. Enron will provide without charge to each person to whom a copy of this Offering Memorandum is delivered in accordance with the procedures established herein, on the request of any such person, a copy of the Transaction Documents or any other information considered to be necessary to verify the accuracy and completeness of the information herein. Written or telephonic requests for such copies should be directed to the Secretary Division, Enron Corp. at its principal executive offices, 1400 Smith Street, Houston, Texas 77002 (telephone number: (713) 853-6161). The Transaction Documents and, upon request, any other information considered to be necessary to verify the accuracy and completeness of the information herein, will also be available to persons

participants. In certain circumstances, Definitive Notes will be issued. See "Description of the New Senior Notes — Book-Entry, Delivery and Form" and "Notice to Investors."

Taxation	Payments of principal and interest in respect of the New Senior Notes will be made free and clear of withholding tax, except to the extent required by applicable law. If the Issuers were required to make such withholding, they would not be obligated to pay any additional amounts in respect thereof.
Indenture Trustee	United States Trust Company of New York.
Paying Agent	United States Trust Company of New York.
Luxembourg Paying Agent	Deutsche Bank Luxembourg S.A.
Euro Paying Agent	Deutsche Bank AG London.
Listing	Application has been made to list the New Senior Notes on the Luxembourg Stock Exchange.
Governing Law	The New Senior Notes and the Indenture will be governed by, and construed in accordance with, the laws of the State of New York.
Transfer Restrictions; Trading ..	The New Senior Notes have not been, and will not be, registered under the Securities Act or under any state securities laws and are subject to certain restrictions on transfer and resale. There is currently no market for the New Senior Notes, and there can be no assurance as to the development or liquidity of a market for the New Senior Notes. See "Risk Factors — Risks Relating to the New Senior Notes — No Registration Rights; Lack of Trading Market" and "Notice to Investors."
Osprey Trust Certificates	\$50,000,000 face amount of New Trust Certificates representing beneficial ownership interests in Osprey to be issued pursuant to the Osprey Trust Agreement are being offered concurrently with the New Senior Notes. See "Description of the New Trust Certificates." The New Trust Certificates are not being offered hereby. The closing of the Offering is conditioned upon the closing of the initial offering of the New Trust Certificates.
Use of Proceeds	Osprey will use the proceeds from the Offering, together with the proceeds from the sale of the New Trust Certificates, to increase its Pledged Osprey Limited Partner Interest. Whitewing LP will use the proceeds to (i) fund the Share Trust with the New Overfund Amount, which will be invested in Enron Debt Securities or other Permitted Investments, and (ii) purchase Permitted Partnership Investments, including Designated Assets. See "Use of Proceeds."

RISK FACTORS

For a discussion of certain matters that should be considered in connection with an investment in the New Senior Notes, see "Risk Factors."

THE HOLDER MUST CHECK THE APPROPRIATE BOX SET FORTH ON THE TRANSFER CERTIFICATE RELATING TO THE MANNER OF SUCH TRANSFER AND SUBMIT THE CERTIFICATE TO THE INDENTURE TRUSTEE. THIS LEGEND WILL BE REMOVED UPON THE REQUEST OF THE HOLDER AFTER THE RESALE RESTRICTION TERMINATION DATE. AS USED HEREIN, THE TERMS "OFFSHORE TRANSACTION," "UNITED STATES," AND "U.S. PERSON" HAVE THE MEANINGS GIVEN TO THEM BY REGULATIONS UNDER THE SECURITIES ACT."

(6) Either:

(a) No part of the assets to be used by such purchaser to acquire and hold the New Senior Notes or any interest therein constitutes assets of any (i) employee benefit plan (as defined in Section 3(3) of ERISA) that is subject to Title I of ERISA, (ii) plan (as defined in Section 4975(e)(1) of the Code) that is subject to Section 4975 of the Code, or (iii) other entity deemed to be investing "plan assets" (within the meaning of 29 C.F.R. Section 2510.3-101 or otherwise under ERISA) of any such employee benefit plan or plan, including without limitation, as applicable, an insurance company general account (each of (i), (ii) and (iii), a "Plan"); or

(b) Assuming that the only Plans with respect to which either of the Issuers is a "party in interest" (within the meaning of Section 3(14) of ERISA) or a "disqualified person" (within the meaning of Section 4975 of the Code) are those Plans sponsored, maintained, contributed to or required to be contributed to by the Issuers or any subsidiary, either (i) no part of the assets to be used by such purchaser to acquire and hold the New Senior Notes or any interest therein constitutes assets of any Plan with respect to which either of the Issuers is a party in interest or disqualified person or (ii) the acquisition and holding of the New Senior Notes or any interest therein by such purchaser will not constitute a non-exempt prohibited transaction within the meaning of Sections 406 and 407 of ERISA or Section 4975 of the Code, by reason of the application of one or more statutory or administrative exemptions.

LISTING AND GENERAL INFORMATION

Application has been made to list the New Senior Notes on the Luxembourg Stock Exchange. Prior to the listing, a legal notice ("*Notice Légale*") relating to the issue of the New Senior Notes, the Osprey Trust Agreement and the Certificate of Incorporation and By-laws of the Co-Issuer will be deposited with the Chief Registrar of the District of Luxembourg ("*Greffier en Chef du Tribunal d' Arrondissement de et à Luxembourg*"), where copies thereof may be obtained, free of charge, upon request.

As long as any of the Senior Notes are outstanding, copies of the Osprey Trust Agreement, the Certificate of Incorporation and By-laws of the Co-Issuer and the Indenture will be available for inspection and any annual and interim semi-annual consolidated financial statements of Osprey will be obtainable at the offices of Deutsche Bank Luxembourg S.A., 14 Boulevard F.D. Roosevelt, L-2450 Luxembourg (the "Listing Agent"), where copies thereof may be obtained upon request. No financial statements will be prepared by, or on behalf of, the Co-Issuer. The Indenture requires the Issuers to provide audited consolidated financial statements to the Indenture Trustee and the holders of the Senior Notes within 120 days after the end of each fiscal year, beginning December 31, 2000. The Indenture requires such financial statements to be audited by a firm of independent certified public accountants of recognized national standing. Osprey does not publish financial statements on an unconsolidated basis. There are no published financial statements yet available for the Issuers.

Copies of the Osprey Trust Agreement, the Certificate of Incorporation and By-laws of the Co-Issuer, the resolutions of the Board of Directors of the Co-Issuer authorizing the issuance of the Senior Notes and the Indenture will be available for inspection during the term of the Senior Notes in Wilmington, Delaware, at the office of the Osprey Trustee, at the office of the Indenture Trustee in New York, New York, and at the office of the Listing Agent (for so long as the Senior Notes are listed on the Luxembourg Stock Exchange).

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